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255-7

United States
Court of Appeals
for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Appellant,

vs.

ROSS B. HAMMOND,
Appellee.

Transcript of Record

In Two Volumes

VOLUME I.

(Pages 1 to 336, inclusive)

Appeal from the United States District Court
for the District of Oregon

FILED

MAR - 4 1949

United States
Court of Appeals
for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Appellant,

vs.

ROSS B. HAMMOND,
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for the District of Oregon

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NAMES AND ADDRESSES OF ATTORNEYS

HENRY L. HESS,
U. S. Attorney;

VICTOR E. HARR,
Assistant U. S. Attorney,
U. S. Court House, Portland, Oregon.

THOMAS R. WINTER,
Special Assistant to the U. S. Attorney,
Smith Tower Building, Seattle, Washington
For Appellant.

ROBERT T. JACOB,

JEROME S. BISCHOFF,

RANDALL S. JONES,
Public Service Building, Portland, Oregon,
For Appellee.

In the District Court of the United States
for the District of Oregon

No. Civ. 3078

ROSS B. HAMMOND,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Defendant.

COMPLAINT

Comes now the Plaintiff herein and for cause of suit against the above named Defendant alleges:

I.

That Plaintiff is an individual taxpayer, resident and domiciled in the State of Oregon, and was during all the times herein mentioned engaged in the general contracting business, as member of a co-partnership, doing business under the firm name and style of Ross B. Hammond Company. Said partnership at all times herein mentioned was composed of Ross B. Hammond and William A. Hammond.

That, at all times herein mentioned, Plaintiff was also engaged in operating a ranch in the State of Oregon.

II.

That at all times herein mentioned, Defendant was and now is United States Collector of Internal Revenue for the District of Oregon, stationed at Portland, Oregon.

III.

Jurisdiction of the within cause rests on the provisions of the Judicial Code of the United States, Section 24, as amended (28 USCA, Subdivision 5, Section 41), and the provisions of Sections 322, 3772, 22 and 23 of the Internal Revenue Code of the United States.

IV.

That the amount in controversy exceeds the sum of \$3000.00. [1*]

V.

That on November 6, 1944, Defendant assessed Plaintiff with a deficiency in income and surtaxes in the sum of \$145,537.77 together with interest in the sum of \$11,609.13, and Plaintiff paid said sums on August 14, 1945 to Defendant.

VI.

That said deficiency assessment and collection was illegal in that Defendant refused to recognize the partnership entity of the Ross B. Hammond Company, and made arbitrary reallocations of income.

VII.

That on or about the 22nd day of August, 1945, Plaintiff filed with the Commissioner of Internal Revenue his claim for refund of said taxes and interest illegally collected and retained; that said claim was in all respects in due and proper form setting forth all of the material facts and grounds upon which said claim for refund was based.

* Page numbering appearing at foot of page of original certified Transcript of Record.

VIII.

That more than six months have elapsed since the filing of the above described claim and the Commissioner has neither allowed nor rejected said claim.

Wherefore, Plaintiff prays for judgment against the Defendant in the principal sum of \$157,146.90 together with interest thereon as provided by law, and for its costs and disbursements incurred herein.

March 15, 1946.

/s/ ROBT. T. JACOB,
/s/ JEROME S. BISCHOFF,
Counsel for Plaintiff.

[Endorsed]: Filed March 16, 1946. [2]

[Title of District Court and Cause.]

ANSWER

The defendant, by his attorneys, Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, and for answer to the complaint on file herein states:

I.

The defendant is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraphs I to VIII

inclusive, and therefore denies the same and the whole thereof.

Wherefore, defendant asks that the complaint herein be dismissed and that he have his costs and disbursements herein.

HENRY L. HESS,
United States Attorney,
/s/ VICTOR E. HARR,
Assistant United States
Attorney. [3]

(Acknowledgment of Service.)

[Endorsed]: Filed July 19, 1946. [4]

[Title of District Court and Cause.]

NOTICE

To the above-named plaintiff and to Jacob, Jones & Brown, his attorneys:

You and each of you will please take notice that on Monday, October 27, 1947, at the hour of 10 o'clock a.m., or as soon thereafter as counsel may be heard, the defendant will call up for hearing his motion to file an amended answer and to have the United States be made a party to this proceeding, as more fully appears in said motion, proposed amended answer, additional defense and alternative affirmative defense and counter-claim of the defendant and the United States of America,

and affidavit attached thereto, copies of which are herewith being served upon you.

Dated this 17 day of October, 1947.

/s/ HENRY L. HESS,
United States Attorney,

/s/ VICTOR E. HARR,
Assistant United States
Attorney,

/s/ THOMAS R. WINTER,
Special Assistant to the
United States Attorney. [5]

[Title of District Court and Cause.]

MOTION

Comes now the defendant, J. W. Maloney, United States Collector of Internal Revenue, for the District of Oregon, by his attorneys, Henry L. Hess, United States Attorney for the District of Oregon, Victor E. Harr, Assistant United States Attorney, and Thomas R. Winter, Special Assistant to the United States Attorney for said District, and moves the Court for an order authorizing said defendant to file his amended answer herein and to make the United States a party hereto.

Said motion is based upon the files and records

in this case and upon the affidavit of Thomas R. Winter, attached hereto.

Dated this 17th day of October, 1947.

/s/ HENRY L. HESS,

United States Attorney,

/s/ VICTOR E. HARR,

Assistant United States

Attorney,

/s/ THOMAS R. WINTER,

Special Assistant to the

United States Attorney. [6]

State of Washington,

County of King—ss.

AFFIDAVIT

Thomas R. Winter, being first duly sworn on oath, deposes and says:

That he is one of the attorneys for the defendant in the above-entitled action and he is informed and believes that, since the commencement of this action, an investigation of the plaintiff's tax liability for the year 1942 discloses that the income of the alleged partnership for the year 1942 in the amount of \$86,635.88 was not reported by, or taxed to, the plaintiff; that income of the alleged partnership for the year 1943 in the sum of \$77,366.37 was not reported by, or taxed to, the plaintiff; that plaintiff has not overpaid his income taxes for the period involved in the action, but, on the contrary, has underpaid his taxes to the extent of the Federal Income taxes computed on the above additional taxable income; that this action involves a determina-

tion of the plaintiff's total tax liability for the years 1942 and 1943, and the United States, in this action, is entitled, therefore, to appear and affirmatively pray for an affirmative judgment against the plaintiff in the sum of \$6,554.03, with interest from November 21, 1945, and costs, as will more fully appear in the defendant's Amended Answer and Counter-Claim of the United States of America; that the United States is a necessary party to this action in order that the Court may fully determine the issues involved, and the appearance of the United States in this action will avoid a multiplicity of suits.

/s/ THOMAS R. WINTER.

Subscribed and sworn to before me this 16th day of Oct., 1947.

(Seal) /s/ PHILIP TINDALL,
Notary Public in and for the State of Washington,
residing in Seattle.

[Endorsed]: Filed October 17, 1947.

[7]

[Title of District Court and Cause.]

OBJECTIONS TO THE MOTION OF DEFENDANT FOR LEAVE TO FILE AN AMENDED ANSWER

Comes now plaintiff above named and objects to the motion of defendant dated October 17, 1947, for leave to file the amended answer tendered with the said motion, on the following grounds:

1. Defendant fails to make any showing that the failure to incorporate the new matter in the original

answer was due to excusable mistake, inadvertence or neglect.

2. Defendant fails to make any showing of diligence to ascertain the matters now tendered by the amended answer.

3. The counter-claim or set-offs denominated "additional defense" and "alternative affirmative defense and counter-claim" introduces for the first time entirely new causes of action by the defendant against the plaintiff.

4. The said counter-claims and set-offs denominated "additional defense" and "alternative affirmative defense and counter-claim" are barred by the Statute of Limitations incorporated into the Internal Revenue Act (Section 275 of the Internal Revenue Act, Title 26, U.S.C.A., Section 275, subdivision (a).)

These objections are based upon the records and files of this cause filed herein and upon the affidavit of Robert T. Jacob, verified October 24, 1947, filed simultaneously herewith.

Dated October 24, 1947.

/s/ ROBERT T. JACOB,

/s/ S. J. BISCHOFF,

Attorneys for Plaintiff. [8]

AFFIDAVIT

State of Oregon,

County of Multnomah—ss.

I, Robert T. Jacob, being duly sworn, on oath depose and say that I am one of the attorneys for the plaintiff in the above entitled action and I am familiar with the facts and circumstances out of

which the cause of action set forth in the pleadings arose and with all of the proceedings had and taken herein.

The cause of action set forth in the complaint is for the recovery of a refund of income tax for the year 1943 paid by the plaintiff to the defendant pursuant to an assessment made by the Commissioner of Internal Revenue on July 27, 1945. The assessment of the tax was made pursuant to a Revenue Agent's report and a proposal of an assessment made by the Commissioner of Internal Revenue on November 6, 1944.

The chronological order of the proceedings in this cause is as follows:

March 16, 1946: Complaint filed.

May 16, 1946: Motion by defendant for 30 days extension to file answer.

May 20, 1946: Order granting 30 days extension to file answer.

June 14, 1946: Motion by defendant for an additional 30 days extension to file answer.

June 17, 1946: Order granting said Motion. [9]

July 19, 1946: Answer filed by defendant, consisting of a general denial, without any affirmative defense, counter-claim or set-off.

October 7, 1946: Order setting pre-trial November 12, 1946.

October 28, 1946: Order cancelling pre-trial and resetting pre-trial November 25, 1946.

November 25, 1946: Order resetting pre-trial to January 6, 1947.

December 23, 1946: Order resetting pre-trial to January 2, 1947.

January 2, 1947: Order striking case from pre-trial and trial calendars.

October 18, 1947: Present motion for leave to file amended answer and counter-claims and set-off in this cause, accompanied by proposed amended answer.

To provide the court with an explanation of the relationship between the issues tendered by the original pleadings and the new issues now sought to be raised by the Amended Answer, counter-claims and set-offs, I set forth herein the following facts:

The Revenue Agent's report upon which the deficiency in income taxes was assessed and paid did not assert or charge the plaintiff (taxpayer) or his partnership with withholding from their income tax returns any item of revenue or gross income received or accrued in the tax years in question; neither did the report upon which the assessment was made charge the plaintiff (taxpayer) or his partnership with including in their returns any unallowable items of expense or deduction.

The sole basis for the assessment set forth in said report was

(a) The claim that W. A. Hammond was not a partner with plaintiff and that all income from the business of Ross B. Hammond Company should be charged to plaintiff, and

(b) In said report, the agent shifted the in-

come and expenses of the years 1941, 1942, 1943 and 1944 from one year to [10] another by arbitrarily applying the "percentage of completion" method of accounting to the business of the taxpayer and his partnership instead of applying the accrual method of accounting as employed by them.

Said agent's report and the assessment based thereon were not predicated upon any of the factors or issues now tendered in the amended answer as a basis for a counter-claim and set-off, but the issues now tendered are entirely new and involve solely the question whether the compensation (share of profits) to be paid to the employees, Mason and Peterson, was properly accrued in the years reported by the taxpayer. No such controversy was presented by the Revenue Agent's report of November 6, 1944, or by the assessment notice based thereon.

The right of the Commissioner of Internal Revenue to assess any deficiency in tax against the plaintiff by reason of the facts set forth in the counter-claim and set-off expired on March 15, 1944, by virtue of Section 275 of the Internal Revenue Act, Title 26 U.S.C.A., Section 275, Subdivision (a).

No assessment of such tax was made by the Commissioner of Internal Revenue on or before said date and the Commissioner is now barred from raising any question in respect to the matters set forth in the counter-claim and set-off, and was so barred on October 17, 1947, when the motion for leave to file the Amended Answer, counter-claim and set-off was filed herein.

All of the matters set forth in the said amended answer, counter-claim and set-off were well known to the defendant, the Internal Revenue Bureau and its agents on November 6, 1944, at the time said report and proposal of settlement were made. The issue now sought to be raised arises out of the relation between the employees, Mason and Peterson, and the plaintiff and the partnership of which he was a member by virtue of written profit sharing agreements between the parties, and involves the question of the year in which their earnings [11] by way of a share of profits could properly be accrued for tax purposes by the plaintiff and his partnership. The relationship between the said parties was well known to the Revenue Agent who made the said report; the contracts were examined by him during the course of his investigations; the manner in which their profit sharing earnings were carried on the books of the plaintiff and his partnership was known to the Revenue Agent and examined by him during the course of the examination resulting in the said report; his said report of November 6, 1944, discusses the said relationship and the accrual of the earnings of the said Mason and Peterson and discusses all facts and circumstances pertaining to the said relationship and the manner in which the accounts were carried on the books of the plaintiff and his partnership, and the manner in which they were treated for income tax purposes was fully investigated and known to the Revenue Agent making said investigation and report at the time thereof.

Subsequent to the payment of the deficiency assessed pursuant to said report and the commencement of this action to recover the refund, the accounts pertaining to the matters referred to in the counter-claim and set-off were the subject of discussion between counsel for the respective parties and the agents of the government, and at the suggestion of counsel for the defendant, I submitted a proposal of settlement on behalf of the plaintiff in which specific mention of this issue was made. These negotiations and the proposal of settlement preceded December 21, 1946.

In the said proposal of settlement submitted at the request of counsel of defendant as aforesaid, dated December 21, 1946, I set forth, among other things, the following as a basis of settlement:

“2. The division of profits to be made by the Ross B. Hammond Company to H. M. Mason and A. V. Peterson to be accrued in accordance with the income of Ross B. Hammond as adjusted in the R.A.R. dated November 6, 1944.” [12]

* * *

“We have checked the adjustments and tax computations made by Internal Revenue Agent Williams (the agent who made said report of November 6, 1944) to give effect to the adjustments necessary to comply with the terms of this offer, and have found them to be **correct and acceptable** to us as a basis for the settlement.”

This is the same manner that is now referred to in the said counter-claim and off-set and the adjustments and tax computations referred to in said

offer of settlement took into account the accruals of the Mason and Peterson shares of profits.

In the Revenue Agent's report of November 6, 1944, paragraph 10, Schedule 3A, he says, among other things:

“Under date of February 3, 1942, Ross B. Hammond entered into agreements with H. M. Mason and A. V. Peterson, whereby Mason and Peterson were to participate in the profits of Ross B. Hammond Company in the ratio of 20% in the case of Mason and 15% in the case of Peterson. These agreements were entered into by Ross B. Hammond as an individual.”

Throughout the said report he referred to and discussed the said contracts with Mason and Peterson and their profit sharing arrangements and in no way challenged the deductibility of their profit sharing allowances for the years in question.

I am aware of no fact or circumstance which would justify the long delay of the defendant and of the government agency in asserting the contentions now advanced by the said counter-claim and set-off.

/s/ ROBERT T. JACOB.

Subscribed and sworn to before me this 24 day of October, 1947.

(Seal) /s/ J. F. JOHNSON,

Notary Public for Oregon.

My Commission expires: 3/29/51.

[Endorsed]: Filed October 27, 1947. [13]

[Title of District Court and Cause.]

PETITION OF THE UNITED STATES
FOR LEAVE TO INTERVENE

The United States of America, by its attorneys, Henry L. Hess, United States Attorney for the District of Oregon, Victor E. Harr, Assistant United States Attorney, and Thomas R. Winter, Special Assistant to the United States Attorney for said District, respectfully alleges and shows:

I.

That the petitioner is a corporation sovereign and body politic.

II.

That the intervention herein prayed is authorized by the Attorney General of the United States of America, at the request of the United States Commissioner of Internal Revenue.

III.

That the United States has an interest in the matter being litigated in this suit and is a necessary and proper party to the complete determination thereof.

IV.

That the facts with respect to the petitioner's interest in this cause are fully set forth in the Amended Answer, Additional Defense and all Affirmative Defense and Counter [14] Claim of the above-named defendant and this petitioner, which have been heretofore served on the plaintiff herein and submitted to the Court, and by reference made a part hereof.

V.

That no application for relief herein has been made to any **Court or Judge, except as stated above.**

Wherefore, petitioner prays that an order be made granting it leave to intervene herein as additional party and to file its said amended answer, additional defense and alternative defense and counter-claim and directing that service of said amended answer, additional defense and alternative defense and counter claim may be made by delivering a copy thereof to the attorneys for the plaintiff and requiring plaintiff herein to answer said amended answer, additional defense, and alternative defense and counter-claim if he be so advised within twenty days after the service of such order.

/s/ HENRY L. HESS,

United States Attorney,

/s/ VICTOR E. HARR,

Assistant United States
Attorney,

/s/ THOMAS R. WINTER,

Special Assistant to the
United States Attorney.

(Acknowledgment of Service.)

[Endorsed]: Filed Oct. 31, 1947. [15]

[Title of District Court and Cause.]

OBJECTION TO PETITION FOR
INTERVENTION

Comes now the plaintiff above named and objects to the petition of the United States for an order

granting it leave to intervene in this action as a party thereto and for leave to file the tendered amended answer on the ground and for the reason that:

1. The petition fails to disclose that the United States is entitled to intervene under any of the provisions of Rule 24 of the Federal Rules of Civil Procedure.

2. There is no need for intervention by the United States in order to recover the refund referred to in the "Alternative Affirmative Defense and Counterclaim" set forth in the tendered amended answer. The court is authorized and required to grant the relief prayed for in said alternative affirmative defense and counterclaim by the provisions of Title 26, Section 3801, U.S.C.A., if a judgment is rendered for the plaintiff herein for the relief prayed for in the complaint.

Dated November 7, 1947.

/s/ ROBERT T. JACOB,

/s/ S. J. BISCHOFF,

Attorneys for Plaintiff.

(Acknowledgment of Service.)

[Endorsed]: Filed Nov. 10, 1947. [16]

[Title of District Court and Cause.]

ORDER

The above-entitled cause having duly come on for hearing on the motion of the defendant for an order permitting defendant to file the amended an-

swer attached to said motion and to make the United States a party hereto, and upon the petition of the United States for leave to intervene as an additional party to this suit and to file its amended answer, additional defense and alternative defense and counterclaim attached to the aforesaid motion for leave to amend, the defendant and the United States appeared herein by Thomas R. Winter, Special Assistant to the United States Attorney in support of said motion and petition, the plaintiff appeared herein by Robert T. Jacob and S. J. Bischoff in opposition thereto, the court having heard the arguments and considered the affidavits and petitions filed herein by the respective parties, it is

Ordered that the objections filed by the plaintiff to the said motions and petition be and the same hereby are sustained and the said motions and petitions are hereby denied.

Dated November 14th, 1947.

/s/ CLAUDE McCOLLOCH,
Judge.

[Endorsed]: Filed Nov. 14, 1947. [17]

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This cause duly came on for trial on January 12th to January 16th, 1948. The plaintiff appeared herein in person and by Robert T. Jacob and S. J. Bischoff, his attorneys, the defendant appeared herein by Thomas R. Winter, Special Assistant to

the United States Attorney. Evidence was introduced by the parties hereto and the cause was thereupon taken under advisement.

The court now makes and files herein the following

FINDINGS OF FACT

1.

That at all the times herein set forth the plaintiff was an individual taxpayer and resident and domiciled in the State of Oregon and was during all of the times herein mentioned engaged in the general contracting business.

2.

That at all the times herein mentioned, defendant, J. W. Maloney, was the United States Collector of Internal Revenue for the District of Oregon.

3.

Jurisdiction of the above-entitled cause is based on the provisions of Section 24 of the Judicial Court (28 U.S.C.A.), Section 41, Subdivision 5, and the provisions of Sections 22, 23, 322 and 3772 of the Internal Revenue Code of the United States.

4.

The amount in controversy exceeds the sum of \$3,000.00.

5.

On July 27, 1945, the Commissioner of Internal Revenue of the United States assessed against plaintiff a deficiency in income and surtaxes for the taxable year 1943 in the sum of \$145,537.77, together with interest thereon in the sum of \$11,609.13, being a total of \$157,146.90.

6.

Plaintiff paid the said sum as follows: \$150,592.88 was paid in cash on August 17, 1945, and \$6,554.03 was paid by credit allowed for refund on account of overassessment for the year 1941.

7.

That the aforesaid deficiency in income and surtax and the collection thereof by defendant was illegal.

8.

That on August 22, 1945, plaintiff filed with the Commissioner of Internal Revenue a claim for refund of the said taxes and interest illegally collected and retained; that said claim was in all respects in due and proper form and at the time of the commencement of this action more than six months had expired since the filing of said claim for refund and the Commissioner of Internal Revenue had neither allowed or rejected the said claim prior to the commencement of this action.

9.

That the determination of the aforesaid deficiency in income and surtaxes by the Commissioner of Internal Revenue was based upon the report of the Revenue Agent, W. G. Williams, dated November 6, 1944 (Plaintiff's Exhibit 20) and the reasons set forth therein; that the deficiency assessment was due in part to the refusal of the Commissioner to recognize the existence of a partnership between the plaintiff above named and William A. Hammond during the tax years 1942 and 1943 and in part to

the rejection by the Commissioner of [19] the partnership's method of accounting of the income from the partnership business and reporting the income in the income tax returns for said years. More specifically the Commissioner rejected the accrual method of accounting maintained by the partnership and the plaintiff and substituted ^{another} a ~~hybrid~~ [C. McC.] method of accounting based in part upon the accrual method, in part on the percentage of profit method and in part upon completed contract basis.

10.

The plaintiff and William A. Hammond are respectively father and son. William A. Hammond is the only son of plaintiff and his wife. Plaintiff was engaged in the contracting business all his life and had become a very successful and prominent contractor. William A. Hammond was 24 years of age and married when the partnership was formed. The education of his son William was channeled from the earliest childhood to prepare him to engage in the contracting business. It was William's own choice as well. To that end father and son worked together at all times. While a young man and going to grammar and high school the son spent all of his spare time with his father on the various construction jobs that were being carried on, receiving training in that work. Upon graduation from high school, the son went to a university and was graduated as a civil engineer. He immediately went to work for his father performing work which required skill, intelligence and knowledge. On February 3, 1942, plaintiff and Wil-

liam A. Hammond entered into a written partnership agreement by the terms of which the partnership was to continue during their joint lives. The interest of the plaintiff was to be 75 per cent and of William A. Hammond 25 per cent. They were to share in the profits and losses upon that basis. It was provided that each of the partners shall have an equal voice in the control of the business and operation of the partners, that accurate books of account should be kept, that upon dissolution of the partnership or death of either of the partners, the business [20] should be wound up, the debts paid and the surplus divided according to their aforesaid interests in the partnership. They agreed that plaintiff should not withdraw from the partnership any more than \$22,500.00 a year and William A. Hammond \$7,500.00 a year and that the excess earnings should be permitted to remain and be used as working capital of the company.

11.

This partnership agreement was entered into at that time because William A. Hammond intended to go to Brazil and engage in the contracting business there. Plaintiff and his wife were eager for their son to remain in Portland and to engage in the contracting business with the plaintiff. Plaintiff persuaded William A. Hammond to refrain from going to Brazil by taking him into the partnership with him at that time.

12.

After the written partnership agreement was entered into and executed on February 3, 1942, the

son was made General Manager of the partnership business, suitable offices were set up for him in the offices of the Company, his activities were greatly increased, he acted as chief engineer for large projects with a large staff of engineers under him. He personally negotiated the contracts for large construction jobs, supervised the work of making bids on the contracts and did a great deal of work that required great responsibility as well as knowledge, experience and ability and in every respect performed functions normally performed by the partner in the management, operation and control of the business. The court finds that the partnership agreement was actually entered into, that it was made in good faith, that it was actually carried out thereafter in good faith and that the said William A. Hammond contributed substantially to the control and management of the business and performed vital additional services which contributed substantially to the production of the income of the business during all of the [21] tax years in question.

13.

At the time that the partnership was entered into between plaintiff and his son, as aforesaid, it was determined by them to keep the said partnership agreement secret between them for the time being because two of the key employees of the plaintiff who were essential to the successful operation of the business were insisting upon being given a partnership interest in the business. Plaintiff was unwilling to take them into partnership with him

and it was feared that if the formation of the partnership between plaintiff and his son were disclosed that these two men would terminate their employment, creating very serious impairment to the business. Because of the agreement to maintain secrecy, it was necessary for the plaintiff to continue to take all contracts in his own name and ostensibly carry on the business in his name. The court finds that the secrecy was maintained for a valid business reason and not for any fraudulent or unlawful purpose and as soon as the need for secrecy disappeared the existence of the partnership was made public.

14.

Prior to the tax year 1938 plaintiff conducted his contracting business in the name of a corporation. The corporation kept its books and reported its income on a percentage of completion basis but plaintiff individually kept his records and reported his personal income on the cash basis. The corporation was dissolved as of the end of the year 1938 and thereafter and until the formation of the said partnership the plaintiff conducted the contracting business in his own name. At the time of the dissolution of the corporation, the corporation had been engaged in the construction of the State Capitol Building for the State of Oregon at Salem, Oregon. Upon dissolution of the corporation, plaintiff individually completed the construction of that project. In 1937 the corporation reported the income from that project on the percentage of completion basis. In 1938, plaintiff applied to the Commis-

sioner of Internal Revenue for permission [22] to adopt individually the accrual method of accounting except as to the income to be reported from the completion of State Capitol building project. He excepted that project from the accrual method and requested permission to report the remainder of that project on the percentage of completion method in order that the method of accounting as to that particular project should be consistent.

15.

In 1938 the Commissioner of Internal Revenue granted to the plaintiff permission to maintain his accounts and to report his income on the accrual method except as to the remainder of the State Capitol project and the court finds that plaintiff did in and after 1938 maintain his accounts and reported his income to the Commissioner of Internal Revenue upon the accrual method except that in 1938 he reported the balance of the State Capitol project on the completion method of accounting.

16.

That during all of the time since 1938 to and including the tax years in question the plaintiff and the said partnership uniformly adopted and maintained the accrual method of accounting and reported their income to the Commissioner of Internal Revenue upon that method of accounting; that no change was made by them in the method of accounting and reporting income during all of said time. .

17.

The court finds that the accounts were honestly, straightforwardly, frankly and fairly kept and maintained during all of the tax years in question, the accounts clearly reflected the income of the partnership and of the plaintiff and that the method of accounting was not maintained or carried on with any purpose of evading or minimizing plaintiff's tax liability. [23]

18.

The court finds that during the tax years in question, plaintiff and the said partnership accrued on their books all income which they had the right to receive and accrued as deductions all liabilities incurred for expense in the operation of the business and that all accruals of income and of deductions were properly entered upon the books of the partnership and were properly reflected in the income tax reports in the tax years in question, that the Commissioner of Internal Revenue had no basis in fact or in law for the rejection of plaintiff's method of accounting and reporting the income for the tax years in question and the substitution of another method and that the method of accounting employed by the Commissioner of Internal Revenue was in ~~any event~~ [C. McC.] an improper method of accounting since it was partly accrual and partly transactional being based in part upon the accrual basis adopted by plaintiff and in part upon the percentage of profit basis and in part upon the completion of contract basis.

On February 3, 1942, plaintiff entered into a profit sharing agreement with an employee, Henry M. Mason, in words and figures as follows:

“AGREEMENT OF EMPLOYMENT

This Agreement, made and entered into on this 3rd day of February, 1942, by and between Ross B. Hammond, sole proprietor, doing business as Ross B. Hammond Co., hereinafter called “First Party,” and Henry M. Mason, hereinafter called “Second Party.”

Witnesseth:

Whereas the Second Party has been in the employ of the First Party almost continuously for a period of thirteen years, and the First Party recognizing the value of the services, ability, and trustworthiness of the Second Party, and the First Party wishing to permit the Second Party to participate in the profits of the First Party’s contracting business; and

Whereas, the Second Party has been acting as General Superintendent and General Manager of the construction business of the First Party, with full power of attorney to sign all documents, and subject [24] only to direction of the First Party; and

Whereas, the Second Party has been acting as General Superintendent and General Manager of the construction business of the First Party, with full power of attorney to sign all documents, and

subject only to direction of the First Party; and

Whereas the First Party wishing to have the Second Party assume a greater responsibility in connection with the management of the general contracting activities of the First Party;

Now, Therefore, the Parties hereto, agree as follows:

1. Compensation of Second Party and Method of Payment: The First Party hereby agrees that he will pay for the services of the Second Party by permitting him to participate in the net profits of the operation of the First Party's construction business upon the basis of twenty (20) per cent of the profits earned each calendar year, after all operating, financing, administrative, and other like expenses have been deducted, but before deduction of State and Federal Income Taxes.

It is specifically understood and recognized between the parties that the operations of this business require the use of large sums of money to be available for financing the operation of the construction and contracting business, and, therefore, to insure the continued success of the business and to provide ample working capital, it is hereby agreed that the earnings of the Second Party shall be paid to him on a basis of a drawing account of Five Hundred (\$500.00) Dollars per month, but the Second Party will not be permitted to withdraw in excess of Ten Thousand Dollars (\$10,000.00) per year. Any funds amounting to more than \$10,000.00 per year shall be permitted to remain in the company, to be used for working capital for use in

that shall be permitted to remain under the control of the First Party for financing and working capital of the construction business of the First Party shall bear no interest.

2. Cancellation: This agreement may be cancelled by either party giving the other party 90 days' written notice, and/or the same may be changed or modified at any time by mutual consent of the parties hereto. It is further understood and agreed that said contract will be automatically cancelled if the said Second Party should leave the employ of the First Party of his own accord.

The Second Party further expressly agrees that should he sever his connection with First Party and desire to withdraw the earnings accumulated to his account, he will give one year's written notice thereof to the First Party, and the First Party will not be obligated to pay such funds to the Second Party until one year after receipt of said written notice [25] from the Second Party.

Should Second Party elect to cancel this agreement or voluntarily leave the service of the First Party, then, and in either event, Second Party shall not receive any percentage of any profit earned by the First Party upon any work done or any contracts entered into during such calendar year, and the payment to the said Second Party of an amount equal to \$500.00 per month for the time employed during such current calendar year shall constitute full and complete payment for all services and/or

the use of the funds of the said Second Party for said current calendar year.

Should the First Party desire to cancel this agreement, he shall notify the Second Party in writing ninety (90) days prior to the date of such cancellation and the compensation due the Second Party shall be upon the basis of twenty (20) per cent of the net profits, as described in paragraph 1 hereof, as shown by the books of the First Party, from January 1st of that year to the date of written notice of cancellation, plus \$1,500.00 to cover compensation for the 90 days employment service from the date of the written notice.

3. Drawing Account: Should the drawing account of \$500.00 per month, or \$6,000.00 per year, as defined in Paragraph 1 above, exceed in any calendar year the percentage of profits to which the Second Party is entitled under this agreement, this difference between the amount of money to which the Second Party is entitled for his services on the basis of this agreement, as outlined in Paragraph 1, shall be charged against any moneys which have accrued to the account of the Second Party, and the amount of money owing the Second Party by the First Party shall be reduced by this amount.

4. Nature of Agreement: It is expressly understood and agreed by and between the parties hereto that this agreement is a contract of employment and that the Second Party does not hereby acquire a proprietary interest in the business of the First Party, but the amounts paid to Second Party shall represent compensation for services rendered.

In Witness Whereof, the parties hereto have affixed their names and seals to the within agreement on the day and date first above given.

ROSS B. HAMMOND CO.

By /s/ R. B. HAMMOND,
First Party.

/s/ H. M. MASON,
Second Party.

Subscribed and sworn to before me, the undersigned, a Notary Public, on this 3rd day of February, 1942.

/s/ ROSALIE NOVAK,
Notary Public for Oregon.

My Commission expires 10/21/42." [26]

20.

On the same date plaintiff entered into a profit sharing agreement with an employee, A. V. Peterson, which is the same as the foregoing contract except that the share of the profits was to be 15 per cent and the monthly withdrawal was limited to \$400.00 per month with a maximum annual withdrawal of \$7,500.00 per year.

21.

During the tax year 1942, the share of the profits earned by the said Mason and Peterson computed in accordance with the terms of the said contracts was the sum of \$86,635.88 and for the tax year 1943 the share of the profits earned by the said Mason and Peterson computed in accordance with the said contracts was the sum of \$77,366.37. That

the share of the profits of the said Mason and Peterson for said tax years was computed upon the same basis as the plaintiff's profits were computed in accordance with the method of accounting employed by plaintiff and in accordance with the income reported by the plaintiff to the Commissioner of Internal Revenue. That the share of the profits earned by the said Mason and Peterson in said years was credited to their accounts in the said tax years and accrued on the books of the company and said profits were charged against the contracts upon which the said Mason and Peterson performed their services in order to determine the profit or loss from said contracts in the said tax years.

22.

The court finds that the said contracts were actually entered into on said dates, that they were made in good faith, that the said employees earned in said years the amount of the profits credited to them and accrued on the books in said years, that the profits so accrued to them were proper deductions in the said tax years as expense in reporting plaintiff's income for the tax years 1942-1943; that said profits were subsequently paid to them in cash, and that there is no basis in fact or in law for the disallowance of those two items as deductions in the said two tax years. [27]

23.

The court finds that when the Revenue Agent made the examination of plaintiff's books in Au-

gust, 1944, resulting in his report dated November 6, 1944 (Plaintiff's Exhibit 20), the Revenue Agent examined the said contracts and had knowledge of all of the facts pertaining to the deduction of the share of the profits accrued to them in the said two tax years in question, that he examined into the propriety of the said deductions and that the said Revenue Agent in said report did not disallow or reject the said deductions by reason of the accrual of the Mason and Peterson share of the profits as deductions and the Commissioner of Internal Revenue did not determine and assess any deficiency in income tax by reason of said transactions.

24.

This action for refund was commenced on March 16, 1946. On July 19, 1946, defendant interposed its answer herein consisting of a general denial but did not set up any counterclaim, set-off or defense predicated upon the claim that Mason's and Peterson's share of the profits accrued in 1942 and 1943 were improperly taken as deductions. On October 18, 1947, defendant filed a motion herein for leave to file an amended answer in which for the first time it was claimed that the said items should not be allowed as a deduction in those tax years and that the income tax of the plaintiff should be re-computed by increasing its income by said amounts. Plaintiff objected to the allowance of the motion on the ground that the defendant failed to make any showing why the matters tendered by said pro-

posed amended answer were not presented at an earlier date; that there was no showing of due diligence; that the said amendment introduced a new cause of action by the defendant against the plaintiff; and that the set-off denominated "Additional Defense" was barred by the statute of limitations contained in the Internal Revenue Code. After extensive hearing upon said motion and objections, an order was entered herein on November 14, 1947, overruling defendant's motion for leave to interpose said set-off. This order [28] was made on all of the grounds stated in the said objections. Upon the trial of the action, the court permitted evidence to be introduced upon said issue subject to plaintiff's objection and has reconsidered all of the objections heretofore made in the light of the evidence introduced upon the trial and the court now finds that all of the said objections were well taken and also finds that upon the merits the share of the profits credited on the books of the plaintiff and the partnership to the said Mason and Peterson and accrued as expense and deductions were in any event properly entered and taken.

25.

The court finds that the deficiency in income tax assessed by the Commissioner of Internal Revenue as aforesaid and collected by the defendant as aforesaid were illegal and that plaintiff is entitled to recover the said payments with interest thereon at the rate of six per cent per annum from the date that the collector received payment thereof.

26.

In determining the deficiency in income tax and surtaxes for the year 1943 which resulted in the aforesaid unlawful assessment and collection, the Commissioner of Internal Revenue determined that a part of the income reported by plaintiff for the tax year 1941 was erroneously included in that year and that said portion should have been included in the subsequent tax years of 1942 and 1943 and by reason thereof the Commissioner of Internal Revenue determined that taxpayer was entitled to a refund of a portion of the income tax paid in 1941 to the extent of \$6,554.03. When the defendant collected the aforesaid unlawful assesment of the sum of \$157,146.90, he allowed a credit to the plaintiff on account thereof to the extent of \$6,554.03 which should have been paid to the plaintiff as a refund under the Commissioner's determination and accepted in addition to said credit the aforesaid sum of [29] \$150,592.88 in payment of the aforesaid unlawful assessment. Subsequent to the commencement of this action, the United States of America commenced an action in this court against Ross B. Hammond, the plaintiff above named, Civil Action No. 3964, for the recovery of the aforesaid sum of \$6,554.03 in the event that this court determines in this action that plaintiff is entitled to recover the full sum of \$157,146.90. Upon the trial of the action, it was stipulated in effect that instead of trying the aforesaid action, No. 3964, adjustment shall be made with respect to the said credit of \$6,554.03 in accordance with the ulti-

mate determination of the court in this action. Since plaintiff only paid the sum of \$150,592.88 and received credit for the said sum of \$6,554.03, plaintiff is entitled to recover herein the sum of \$150,592.88 with interest thereon at the rate of six per cent per annum from the aforesaid date of payment and is entitled to the entry of a judgment dismissing the aforesaid action No. 3964 with prejudice.

Upon the foregoing findings of fact, the court makes and files herein the following

CONCLUSIONS OF LAW

1. That plaintiff has sustained the allegations of the complaint by a preponderance of the evidence.

2. That the deficiency in income tax and surtaxes assessed against and collected from the plaintiff were unlawful, ~~arbitrary~~ [C. McC.] and without just cause.

3. That plaintiff and the partnership of which he was a member had the right to maintain their accounts on the accrual method of accounting and to report their income on said basis during the tax years in question.

4. That the books of account of the plaintiff, during the tax years in question, were maintained on a true and accurate accrual basis and that his income tax reports were made on a true and correct accrual basis in accordance with the said accounting [30] method.

5. That the Commissioner of Internal Revenue had no authority under the facts in this case to reject plaintiff's method of accounting and to substitute another method.

6. That plaintiff's method of accounting and reporting income clearly reflected the income during the tax years in question.

7. That the method of accounting employed by the Commissioner of Internal Revenue was not authorized or warranted by any provision of the Internal Revenue Code or Regulations.

8. That the partnership agreement entered into between plaintiff and William A. Hammond was entered into and carried out in good faith, the business of the said partnership was carried on by them as co-partners during the tax years in question and the Commissioner of Internal Revenue was not justified in rejecting the said partnership in computing plaintiff's income tax liability for the tax years in question.

9. The defendant is not entitled to set-off against plaintiff's claim for refund any claim for additional tax arising out of the accrual of the Mason and Peterson share of the profits in the tax years in question because (a) the said set-off was not interposed timely and no showing of diligence for the failure to do so was made to the court, (b) the right of the Commissioner of Internal Revenue to assess additional tax by reason of said transactions was barred by the statute of limitations at the time defendant attempted to interpose the set-off (the Com-

missioner of Internal Revenue did not at any time make any determination or assessment of any deficiency in income tax by reason of said transactions), and (c) upon the merits the Commissioner of Internal Revenue could not have lawfully assessed any deficiency in income tax by reason thereof.

10. Plaintiff is entitled to recover from the defendant the taxes unlawfully collected from the plaintiff as set forth in the findings of fact. [31]

11. The court directs that judgment be entered in favor of the plaintiff and against the defendant for the sum of \$150,592.88 with interest thereon at the rate of six per cent per annum from August 17, 1945, together with his costs and disbursements incurred herein and for the entry of a judgment in the action No. 3964 dismissing said action with prejudice. The foregoing shall be an opinion within 28 U.S.C.A. Sec. 764.

Dated: April 21st, 1948.

/s/ CLAUDE McCOLLOCH,
Judge.

Service of the within Findings of Fact and Conclusions of Law by receipt of a duly certified copy thereof, as required by law is hereby accepted in Multnomah County, Oregon, on this 21st day of April, 1948.

/s/ VICTOR E. HARR,
Attorney for Defendant.

[Endorsed]: Filed April 21, 1948. [32]

In the District Court of the United States
for the District of Oregon

Civil No. 3078

ROSS B. HAMMOND,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,

Defendant.

JUDGMENT

This cause having duly come on for trial on January 12th to January 16th, 1948, the plaintiff appeared herein in person and by Robert T. Jacob and S. J. Bischoff, his attorneys, the defendant appeared herein, by Thomas R. Winter, Special Assistant to the United States Attorney, Findings of Fact and Conclusions of Law have been made, filed and entered herein, now on motion of S. J. Bischoff, attorney for the plaintiff, it is

Considered, Ordered and Adjudged that the plaintiff, Ross B. Hammond, do have judgment for and recover of and from the defendant, J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, the sum of \$150,592.88, with interest thereon at the rate of six per cent per annum from August 17, 1945, making a total of \$174,788.14, together with the costs and disburse-

ments incurred by the plaintiff in the sum of \$353.89 as taxed by the Clerk of this Court.

Dated April 21st, 1948.

CLAUDE McCOLLOCH,
Judge.

Entered in docket April 21, 1948.

[Endorsed]: Filed April 21, 1948. [33]

[Title of District Court and Cause.]

NOTICE OF APPEAL

To: Ross B. Hammond, plaintiff above-named, and
Messrs. Robert T. Jacob and S. J. Bischoff, at-
torneys for plaintiff.

You and each of you will please take notice that the defendant, J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, appeals to the Circuit Court of Appeals for the Ninth Circuit, from that certain judgment in the above-entitled cause made and entered the 21st day of April, 1948, by the Honorable Claude McCulloch, Judge of the above-entitled court, wherein the plaintiff recovered judgment from the defendant in the sum of \$150,592.88, with interest thereon at the rate of six per cent per annum from August 17, 1945, making a total of \$174,788.14, together with the costs and disbursements incurred by the plaintiff in the sum of \$353.89.

Dated this 15th day of June, 1948, at Portland,
Oregon.

HENRY L. HESS,

United States Attorney for
the District of Oregon.

/s/ VICTOR E. HARR,

Assistant United States
Attorney.

[Endorsed]: Filed June 18, 1948. [34]

In the United States Circuit Court of Appeals
for the Ninth Circuit

Civ. No. 3078

J. W. MALONEY, United States Collector of In-
ternal Revenue for the District of Oregon,
Appellant,

vs.

ROSS B. HAMMOND,

Appellee.

ORDER

This matter coming on to be heard upon motion of Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, for an order extending the time ninety (90) days from the first date of notice of appeal herein for filing the record on appeal and docketing the action, and the Court having considered said motion and the supporting affidavit filed therewith, and being advised, it is

Ordered that the appellant be and he is hereby granted an extension of ninety (90) days from the

date of filing notice of appeal within which to file and docket the record on appeal.

Dated at San Francisco, California, this 16th day of July, 1948.

/s/ FRANCIS A. GARRACHT,
Judge.

A True Copy.

Attest: July 16, 1948.

[Seal] /s/ PAUL P. O'BRIEN,
Clerk.

[Endorsed]: Filed July 16, 1948. Paul P. O'Brien, Clerk.

MOTION

Comes now Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, and based upon attached affidavit moves the Court for an order extending the time for filing the record on appeal and docketing the action, granting to appellant ninety (90) days from June 18, 1948. This motion is based upon Rule 73, Rules of Civil Procedure.

Dated at Portland, Oregon, this 15th day of July, 1948.

HENRY L. HESS,
United States Attorney for
the District of Oregon.

/s/ VICTOR E. HARR,
Assistant United States
Attorney. [36]

[Endorsed]: Filed July 22, 1948. [35]

AFFIDAVIT

United States of America,

District of Oregon—ss.

I, Victor E. Harr, being first duly sworn, depose and say that I am Assistant United States Attorney for the District of Oregon; that I am one of the attorneys of record representing defendant in the case in the District Court of the United States for the District of Oregon, entitled, “Ross B. Hammond v. J. W. Maloney, Collector of Internal Revenue for the District of Oregon, Civil No. 3078”; that Notice of Appeal was duly filed in said cause on the 18th day of June, 1948. The Department of Justice is presently considering the evidence aduced at the trial of the above-named cause, including the partnership issue, the accounting issue, and the issue involving the agreement with the employees, with a view of determining whether or not this appeal will be prosecuted. This affidavit is made in support of a motion for extension of time within which to file the record and docket the appeal.

Dated at Portland, Oregon, this 15th day of July, 1948.

/s/ VICTOR E. HARR.

Subscribed and sworn to before me this 15th day of July, 1948.

[Seal] /s/ FLORENCE McKAY,

Notary Public for Oregon.

My Commission Expires: Sept. 4, 1951. [37]

[Title of U. S. Court of Appeals and Cause.]

ORDER

This matter coming on to be heard upon motion of Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, for an order extending the time thirty (30) days from September 16, 1948, for filing the record on appeal and docketing the action, and the Court having considered said motion and the supporting affidavit filed therewith, and being advised, it is

Ordered that the appellant be and he is hereby granted an extension of thirty (30) days from September 16, 1948, within which to file and docket the record on appeal.

Dated at San Francisco, California, this 13th day of September, 1948.

/s/WILLIAM DENMAN,

Judge.

A True Copy. Attest: Sept. 13, 1948.

[Seal] /s/ PAUL P. O'BRIEN,

Clerk.

[Endorsed]: Filed September 13, 1948. Paul P. O'Brien, Clerk.

[Endorsed]: Filed October 19, 1948. [38]

[Title of U. S. Court of Appeals and Cause.]

MOTION

Comes now Henry L. Hess, United States Attorney for the District of Oregon, and Victor E.

Harr, Assistant United States Attorney, and based upon attached affidavit moves the Court for an order extending the time for filing the record on appeal and docketing the action, granting to appellant thirty (30) days from September 16, 1948. This motion is based upon Rule 73, Rules of Civil Procedure.

Dated at Portland, Oregon, this 10th day of September, 1948.

HENRY L. HESS,

United States Attorney for
the District of Oregon.

/s/ VICTOR E. HARR,

Assistant United States
Attorney. [39]

AFFIDAVIT

United States of America,
District of Oregon—ss.

I, Victor E. Harr, being first duly sworn, depose and say that I am Assistant United States Attorney for the District of Oregon; that I am one of the attorneys of record representing defendant in the case in the District Court of the United States for the District of Oregon, entitled, "Ross B. Hammond v. J. W. Maloney, Collector of Internal Revenue for the District of Oregon, Civil No. 3078"; that Notice of Appeal was duly filed in said cause on the 18th day of June, 1948; that upon motion of appellant the Circuit Court of Appeals granted an extension of ninety (90) days from the date of

filing of notice of appeal within which to file and docket the record on appeal; that the record in this case is quite voluminous, and the issues being complicated, the Solicitor General has not as yet determined whether or not this appeal will be prosecuted. This affidavit is made in support of a motion for extension of time within which to file the record and docket the appeal.

Dated at Portland, Oregon, this 10th day of September, 1948.

/s/ VICTOR E. HARR.

Subscribed and sworn to before me this 10th day of September, 1948.

[Seal] /s/ FLORENCE McKAY,
Notary Public for Oregon.

My Commission Expires: Sept. 4, 1951. [40]

[Title of U. S. Court of Appeals and Cause.]

ORDER

This matter coming on to be heard upon motion of Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, for an order extending the time thirty (30) days from October 16, 1948, for the filing of the record on appeal and docketing the action, and the Court having considered said motion and the supporting affidavit filed therewith, and being advised, it is

Ordered that the appellant be, and he is hereby granted an extension to October 23, 1948, within which to file and docket the record on appeal.

Dated at San Francisco, California, this 15th day of October, 1948.

WILLIAM DENMAN,
Chief Judge, U. S. Court of
Appeals, Ninth Circuit.

A True Copy Attest: Oct. 15, 1948.

[Seal] /s/ PAUL P. O'BRIEN, Clerk.

[Endorsed]: Filed October 15, 1948. Paul P. O'Brien, Clerk.

[Endorsed]: Filed October 19, 1948. [41]

In the District Court of the United States
For the District of Oregon

[Title of Cause.]

STATEMENT OF POINTS ON WHICH
DEFENDANT INTENDS TO RELY ON
APPEAL

The defendant having taken an appeal in the United States Circuit Court of Appeals for the Ninth Circuit, from a judgment rendered by the District Court for the District of Oregon, hereby designates the following points to be relied on in the prosecution of said appeal:

1. The District Court erred in finding and concluding that taxpayer's method of accounting clearly reflected taxable income.

2. The District Court erred in finding and concluding that taxpayer was entitled to deduct a percentage of his profits from the partnership

under profit-sharing agreements with two of his employees.

3. The District Court erred in denying defendant's motion to amend his answer and plead as a set-off that plaintiff had not overpaid his taxes on the grounds that he failed to include in his taxable income for the period involved all of his income from the partnership.

4. The District Court erred in finding and concluding that the Commissioner of Internal Revenue authorized the taxpayer to file his federal income tax returns on the accrual basis of accounting and in not concluding that the Commissioner of Internal Revenue authorized taxpayer to report his long-term contracts on the percentage of completion basis.

5. The District Court erred in not finding and concluding that taxpayer maintained stock piles of material which were not reflected in reporting net income from long-term contracts.

Dated this 19th day of October, 1948, at Portland, Oregon.

/s/ HENRY L. HESS,
United States Attorney.

/s/ VICTOR E. HARR,
Assistant U. S. Attorney. [42]

(Acknowledgment of Service.)

[Endorsed]: Filed October 19, 1948.

[43]

[Title of District Court and Cause.]

DESIGNATION OF CONTENTS OF RECORD
ON APPEAL

To: The Clerk of the District Court of the United
States for the District of Oregon:

Defendant, J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, hereby designates that portion of the record in this case to be contained in the record on appeal, which is described as follows:

1. Complaint, filed March 16, 1946.
2. Answer, filed July 19, 1946.
3. Motion and Notice and Affidavit attached for leave to file an amended answer, filed October 17, 1947.
4. Objections to the Motion of defendant for leave to file an amended answer, and affidavit attached thereto, filed October 27, 1947.
5. Petition of the United States for leave to intervene, filed October 31, 1947.
6. Objections to petition for intervention, filed November 10, 1947.
7. Order sustaining plaintiff's objections to petition for intervention, entered and filed November 14, 1947.
8. Transcript of proceedings of the trial.
9. Findings of Fact and Conclusions of Law, filed April 21, 1948.
10. Judgment, entered and filed April 21, 1948.
11. Notice of Appeal, filed June 18, 1948.
12. Motion, Affidavit and Order of the Circuit Court of Appeals, granting extension of ninety

days from the date of filing Notice of Appeal to file and docket record on appeal, dated July 16, 1948, and filed July 22, 1948. [44]

13. Motion, Affidavit and Order of Circuit Court of Appeals granting extension of thirty days from September 16, 1948 within which to file and docket record on appeal, dated September 13, 1948, filed; October 19, 1948.

14. Order of the Circuit Court of Appeals granting extension to October 23, 1948, to file and docket record on appeal, dated October 15, 1948; filed, October 19, 1948.

15. Statement of Points on which Defendant Intends to Rely on Appeal.

16. Order to send trial exhibits.

17. This designation.

Dated at Portland, Oregon, this 19th day of October, 1948.

/s/ HENRY L. HESS,

United States Attorney.

/s/ VICTOR E. HARR,

Assistant U. S. Attorney.

/s/ THOMAS R. WINTER,

Special Assistant to the U. S.
Attorney.

(Acknowledgment of Service.)

[Endorsed]: Filed October 19, 1948.

[45]

In the District Court of the United States
For the District of Oregon

CLERK'S CERTIFICATE

United States of America,
District of Oregon—ss.

I, Lowell Mundorff, Clerk of the District Court of the United States for the District of Oregon, do hereby certify that the foregoing pages numbered from 1 to 48 inclusive constitute the transcript of record on appeal from a judgment of said court in a cause therein numbered Civil 3078, in which Ross B. Hammond is plaintiff and appellee, and J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon is defendant and appellant; that the said transcript has been prepared by me in accordance with the designation of contents of the record on appeal filed by the appellant, and in accordance with the rules of court; that I have compared the foregoing transcript with the original record thereof and that it is a full, true and correct transcript of the record and proceedings had in said court in said cause, in accordance with the said designation as the same appears of record and on file at my office and in my custody.

I further certify that I have enclosed under separate cover copy of transcript of proceedings dated January 12-16, 1948, pages 1-501, inclusive, together with exhibits Nos. 1 to 20, 24, 26 to 32, 35 and 36, by direction of the United States Attorney.

In Testimony Whereof I have hereunto set my hand and affixed the seal of said court in Portland, in said District, this 20th day of October, 1948.

(Seal)

LOWELL MUNDORFF,
Clerk.

[48]

In the District Court of the United States
For the District of Oregon
Civil No. 3078

ROSS B. HAMMOND,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Defendant.

Portland, Oregon, January 12, 1948, a.m.

Before: Honorable Claude McColloch, Judge.

Appearances: Mr. Robert T. Jacob and Mr. S. J. Bischoff, Attorneys for Plaintiff, Mr. Thomas R. Winter, Special Assistant to the United States Attorney, Attorney for Defendant.

Court Reporter: Ira G. Holcomb.

PROCEEDINGS OF PRE-TRIAL
CONFERENCE AND TRIAL

Proceedings of Pre-trial Conference

The Court: You may proceed, Gentlemen.

Mr. Winter: My records show this case was coming on for pre-trial on the 14th. However, I

was down here on another matter. We would appreciate it if we could have one day intervening between the pre-trial and the trial.

The Court: When is the case set for trial? Tomorrow?

Mr. Bischoff: Tomorrow, your Honor.

Mr. Winter: I did not have any notice. I thought it was just the pre-trial on the 14th.

The Court: You have a case on Wednesday, Mr. Winter?

Mr. Winter: Yes, your Honor, and one on Thursday, I think, before Judge Fee.

The Court: I do not get you. You say you want a day—

Mr. Winter: Wednesday, I think, your Honor, it involves merely a motion for summary judgment. That is the case which was submitted to your Honor on pre-trial order without any testimony. I do not assume that will take more than a few minutes.

The Court: I would be glad to accommodate you if I could, if the calendar were not so involved.

Mr. Winter: I merely made that as a suggestion. I expect to spend two or three days here, or, at least, expected to spend two or three days in preparation for trial. I wrote to the Attorney-General and told him it was coming up on the 14th. [2] I was in court when your Honor set it, but I must have written down the wrong date.

The Court: Then we had better start in tomorrow in accordance with the setting. What is to be done this morning?

Mr. Bischoff: The pre-trial, your Honor.

Mr. Winter: At this time we are asking leave to file an amended answer on behalf of the defendant. We think we are entitled to set up an affirmative defense.

The Court: Is that something I have ruled on already?

Mr. Bischoff: Yes, your Honor.

The Court: All right. My ruling will be the same, unless you want to be heard again.

Mr. Winter: No. We think we can offer the evidence on the general denial. We deny that they reported the correct income, but we want to note an exception to your Honor's refusal to allow the defendant to file an amended answer.

The Court: Exception allowed.

Mr. Winter: Prior to pre-trial.

The Court: Yes.

Mr. Bischoff: There are two matters actually before your Honor. One is the pre-trial in the case of Hammond vs. Maloney and the other is a motion for summary judgment in the case of the United States vs. Hammond, Civil 3964, which was brought subsequent to your Honor's ruling on the motions that have been referred to, presenting, as we view it, the identical [3] issue of law which was already disposed of by your Honor.

Based upon that theory, that your Honor has disposed of the legal question that is controlling in that case, we have filed a motion for summary judgment in that case because in the Hammond case, if your Honor concludes we are entitled to recover, your Honor will be obliged to give the Government the relief which it is seeking by this

action, so, in reality, it may not be necessary to concern ourselves with considering that motion for the time being—that would be my view of it—until your Honor has heard this Hammond case and made some disposition of it. If we do not succeed, we are entitled to retain the money which the Government paid us; if we do succeed, your Honor will be obliged to give them the relief which they ask in that suit, so I can see no point in going into that matter at the present time.

The Court: Then go ahead with the main case.

Mr. Bischoff: This case, as your Honor already knows, is an action to recover a refund of taxes which the plaintiff paid upon the assessment of a deficiency in tax. The tax year involved is the year 1943, and for that year a deficiency in tax of something in excess of \$150,000 was assessed and paid.

We claim the assessment to be unlawful and that we are entitled to recover all the money paid, less the sum of about \$6500 which the Government refunded to us voluntarily and over our objection in arriving at its conclusion resulting [4] in a deficiency assessment.

This tax case is rather unique and interesting from this point of view—most interesting from what it is not rather than what it is. In this case we have no issue as to withholding from the taxpayer's reports or income tax returns of any income. It is not charged that we, either mistakenly or intentionally, withheld any income or failed to report any income that we should have reported. Neither is it a case in which it is claimed that the taxpayer deliberately or mistakenly padded

his deductions so as to minimize his tax liability.

In the last analysis, there is no issue of fact of any consequence that will be determined in this case, as we see the situation, viewed from the Revenue Agent's report out of which this case arises. The true issue will be legal, in my view. It will involve the question of the proper method of accounting. It will involve a sort of academic question in accounting which, in turn, will depend upon the legal interpretation of the meaning of the Revenue Act which provides for the manner in which a taxpayer shall account, that is, what method of accounting he shall employ, and that is, I think, in the last analysis, what your Honor will be called upon to determine.

What happened was this, briefly—and it may be profitable if your Honor will bear with me that I may make a little more extended statement of the situation, because ultimately we have to do that anyhow, either tomorrow or today, and [5] perhaps it would be just as well to do it today.

Ross B. Hammond is a contractor of many years standing in this community. He built this very courthouse and built many large structures in the Northwest. I think it is safe to say he built the largest and most important structures in this part of the country—a man of very high standing in the profession and in the community.

Prior to the tax year 1938, he conducted his contracting business through the medium of a corporation in which he was the largest if not the sole owner of the stock, and he kept his books—that is, the income from the corporate operations were reflected in the corporation's books.

He also, individually, during that period of time, had a few minor enterprises like farms or something or another, which did not amount to a great deal compared to the other operation, and in his personal income tax return he reported on a cash basis.

In 1937 that corporation had the contract for the construction of the State Capitol at Salem, which was being constructed by the corporation, and in that year the corporation kept its records and made its income tax return on what is known under the Revenue Act and regulations as the percentage-of-completion basis, and I will in a few moments explain that method in the technical sense.

But at the end of 1938 and before the Capitol was [6] entirely completed, the corporation was dissolved and the contract was completed in the following year, or substantially completed, except for one and seven-tenths per cent in 1938—was completed by Hammond individually and, for the purpose of being consistent with the method of accounting for this project, he continued to keep the records in connection with that construction job on the percentage-of-completion basis in 1938, and made his income tax return on that basis, so as to have a consistent accounting method to arrive at the profit for that particular contract.

However, anticipating a change in his operations with respect to subsequent contracts, he made application to the Commissioner of Internal Revenue in 1938 for permission to change his individual method of accounting and reporting his income from the cash basis, upon which he had been

theretofore, to the accrual method which he wanted to adopt, and the Commissioner granted that permission to him to adopt the accrual method, beginning with January of 1938.

Your Honor will have to bear in mind what I said before that in 1938 he individually completed that contract and had reported the income on the percentage-of-completion basis, which did not conform to the permission granted to adopt the accrual method, but he was advised that for that particular unfinished contract, in order to clearly reflect the income, he had to report the balance of the contract on the same basis [7] as he had reported prior thereto; otherwise he would have a distorted income basis, and it is generally recognized in accounting that you have to have a consistent basis throughout in order to clearly reflect income—you could not have part of your report on one basis and part on another.

But beginning with the year 1939, from January, 1939, when the Capitol contract was completed, except for this one and seven-tenths per cent, he adopted the accrual method of accounting; his account books were set up on that basis with all of the accounts which are needed to reflect such a method, and consistently carried that method of accounting right on down to the present time, in fact, and including the tax years with which we will be concerned. He made his income tax return upon the accrual method of accounting.

He did that for the year 1939; he did that for the year 1940; he did that for the years 1941,

1942, 1943 and 1944. In our trial we are going to be concerned with the figures that were involved in 1941, 1942 and 1943, and perhaps to some extent with 1944, but from 1939 on there was that consistent practice.

After those returns were filed for the years mentioned, 1939 on down, the Internal Revenue Bureau audited those returns. The return for the tax year 1939 was audited twice and two separate reports were made, and of course it was then known that we were on an accrual basis. They rendered two Revenue Agent's reports which resulted in an over-assessment of some [8] small amount; they claimed he had overpaid some small amount and that amount was refunded to us. No question was raised as to the method of accounting, either that we had the right to use it or that it was accurately kept, except for a minor mistake which resulted in this small refund paid us.

The return for 1940 was audited twice by the Internal Revenue Bureau and two separate Revenue Agent's reports were made that adopted our accrual method of accounting, did not question it, and did not question the accuracy; and in that year again they found an overpayment of about \$160 and refunded it to us.

They audited the return for 1940 and the audit in that year, significantly enough, was made in 1943, the year in which the forgiveness tax act was in effect. They did not question that return on the basis that we had no right to use the accrual method of accounting or, having used the

accrual method, that we had not accurately carried it out. The result of the audit was merely to disclose a deficiency in tax to the extent of some \$200, resulting from some error, not because of the method employed. They did not say we did not have the right to use the accrual method or that the method was not properly carried out, but there was some technical error which resulted in a deficiency, and we paid it.

They audited the return for the year 1941, and that is a highly important year to bear in mind, because they now [9] seek to upset that return, and they seek to upset their own report for that year—

The Court: You are going into another matter now. I want to talk to these other lawyers for a moment.

(The Court then proceeded to the transaction of other business.)

Mr. Bischoff: The return for 1941 was audited in 1943 when the forgiveness act was in effect. The Revenue Agent's report did not there challenge the right to adopt and use the accrual method of accounting, nor to report the income upon that basis, nor did they challenge the accuracy of the return or the manner in which the accounts were kept. The audit resulted only in the determination of a deficiency to the extent of \$278.94, again arising from some erroneous treatment of an individual item, which did not arise from the basic controversy that we have here as to the method of accounting employed and whether or not we

had a right to use that method of accounting. We paid that deficiency as determined, because it was recognized that there was an error in that respect.

At this point, before I go on with subsequent years, I should point out to your Honor that this method of accounting that was adopted and was set in motion in the beginning of 1939 was not and could not have been in anticipation of any such question as arises now in this case; that is, the application and treatment of the forgiveness act which was passed in 1943. [10]

Prior to that time every inclination on the part of any taxpayer would have been to keep his income down for the particular year, rather than the reverse, but certainly it could not have been because there was no such law in existence, and that was unknown. When they set up the books on the accrual method, beginning in 1939, and consistently thereafter, they did not wait until the end of the year to determine whether the income should be accrued in that year or whether it would have been profitable, taxwise, to accrue it in subsequent years, which might have been done, if they had postponed the determination of that question to the end of the year.

In this case, every month, as the income accrued, it was entered on the books and every month's liabilities that were incurred for expenses were entered upon the books and, at the end of the year, the only thing that was carried was the cumulative amount of both of these accounts in

final closing entries, so it could not be suggested here—and, indeed, no contention was made that there was any element of bad faith in the adoption of that method or the manner in which it was carried out. It was an attempt to set up a method, the adoption of an accrual method, which the courts have said is the most scientific and accurate method of reporting income, and that method was consistently and continuously followed out through the years.

In the year 1942 the return was not audited separately. It was audited in the Revenue Agent's report issued in 1944, [11] November 6, 1944, and at that time they re-audited the 1941 return which I just called to your Honor's attention. They audited the 1942 return; they audited the 1943 and the 1944 returns, with the result that two Revenue Agent's reports were rendered, one by which they found, for the first time, or determined for the first time, that our method of accounting on the accrual basis was not permissible; that we had no right to use the method and, therefore, we had, strangely enough, overpaid — we had reported more income in 1941 than we should have and, as a result, the Revenue Agent reported that we had paid \$6500 in taxes more than we should have paid upon the system of accounting which he substituted for the manner that we had reported on.

That was made the basis of a separate Revenue Agent's report, but it is dated the same date as the report which dealt with the years 1942, 1943

and part of 1944, and, apparently, was, we think, contemporaneous. I do not believe there will be any question as to that.

When he found that they had reported too much income in 1944, he threw that excess into 1942. I beg your pardon. When he found that they over-reported their income in 1941, he threw that excess into the year 1942, increasing our income for that year by that amount.

When he examined the 1942 and 1943 returns, which are virtually one return—involve the intervention of the forgiveness [12] act—he determined that a large amount of income reported in 1943 was improperly reported as income for that year and he threw that back into 1942.

In other words, he did both—threw 1941 into 1942, and 1943 into 1942—and, by that means, swelled the amount of income for the year 1942 and diminished the income for the year 1943, with the result that the higher bracket and rate were made applicable to the year 1942, for one thing, but the important thing was that, having diminished the income in 1943, the amount of credit which the forgiveness act entitled to was reduced.

As your Honor will recall, the forgiveness act, passed in 1943, gave a taxpayer the right to deduct 75 per cent of the tax due in either of the two years, whichever was the lower, so the Revenue Agent creates the year 1943 as the lower year and deprives us of 75 per cent credit or the 75 per cent that we would have been entitled to pay upon the income as reported. By that means he

created a deficiency in tax for that year amounting to \$150,000, odd.

That is the procedure and technique by which that was accomplished, and it is our contention here that this method of accounting would never have been challenged, and it was not challenged except for the intervention of the forgiveness act, and this method which the Revenue Agent adopted and upon the Commissioner based his assessment, either intentionally [13] or at least in the legal result, deprived us of the benefits of the consideration which the Congress gave to every taxpayer in that period of time.

The Court: What is the law, pro and con?

Mr. Bischoff: I am just about to come to that, your Honor. Before giving your Honor our views on the law upon that question, I want to point out that when the Revenue Agent re-audited these returns for the years 1941, 1942 and 1943, he did not reject the amounts of income which we reported in these several years; he did not question them; and, in fact, he adopted them. For example, we reported—and your Honor will have these exhibits before you in due time. For instance, we reported on a given job, like the Milwaukie Housing Project, that we got \$36,547.78 in 1941 and \$245,018.89 in 1942, and so on down the line.

Those figures were not challenged, and the Revenue Agent adopted those figures in arriving at the basis of computation that he subsequently adopted—on the computation that he subsequently adopted he applied a percentage basis, which is what he claims to have done to these very figures.

The law, your Honor, in our view with respect to this matter, is this: The Internal Revenue Code gives to the taxpayer the absolute right, the unqualified right, to choose the method of accounting, with this proviso, that the method employed clearly reflects income. That is the phrase that your [14] Honor is going to have to construe here, "clearly reflects income", and let me point out that it does not say "clearly reflects income in a given year", but it merely says "clearly reflects income", and that is going to be significant as I will presently point out.

Provision is made in the Act that if the method employed does not clearly reflect income, the Commissioner of Internal Revenue may re-compute the income. The law in that respect is that when he does determine that the method employed by the taxpayer does not clearly reflect income he must adopt a method of computation; that is, the Commissioner must adopt a method of computation which is recognized by the Internal Revenue Act and by accounting practices. He cannot adopt a hybrid system. That is, he may adopt a cash method or an accrual method or a percentage-of-completion method or a completed-contract method, but he cannot create a method of his own which is part one and part the other.

I have pointed out to your Honor that there were four methods of accounting. Let me first state very briefly—your Honor undoubtedly knows in a general way what was required. There is the cash method which, in simple terms, merely means that

the taxpayer must report his income as income—must report what he has received. He cannot report income that he has not received, no matter what the reason might be, except in rare cases of what is called constructive receipt as, for example, [15] where a taxpayer has a right to receive it but deliberately refuses to take it. For example, somebody tenders him a check on December 31st in payment of a bill and he wishes not to accept it until January 1st. The courts treat that as a constructive receipt but, barring things of that kind which are affected by good faith, on the cash basis he must report only actual receipts and, for his deductions, he can take only actual payments regardless of any liability involved. That is the standard for cash basis accounting.

Under the accrual system, the reverse is true. The receipt of revenue as income, in fact, plays no part. It is the time when his right to receive payment accrues, as, for example, a merchant had sold a bill of goods on December 1st and he has issued an invoice for it. The right to receive that has accrued as an account receivable and he must throw that in, in that year, as revenue, even though it is paid in a subsequent year and even though it may never be paid by reason of the insolvency of the debtor.

With respect to his deductions, he is permitted and, in fact, is compelled to report all the indebtedness that he has incurred. Whenever he has any liability to pay a bill of merchandise or labor or material, whatever the case may be, he must treat

it in that year as a deduction, regardless of when he pays that bill. The essentials are the right to receive that revenue and the obligation to pay for liabilities [16] incurred. That is the standard for the accrual basis. The authorities which we will give your Honor will fully support what I am now saying about this.

The regulations set up two permissible methods of accounting which relate to a contracting business. The Regulations permit him the right, but do not make it compulsory, to adopt one of two methods, the percentage-of-completion or a completed-contract basis.

Take the latter first, the completed-contract basis: Under that system, when a contract extends over a period of more than one year, the contractor can defer the reporting of income and deductions until the final completion of the contract. In other words, in the first year of his operation, if a contract is not completed, he need not report receipts or expenditures, but he is required to make a complete report of the operation after his revenues and expenditures have been determined, and his profit is thereby determined. That is the completion method of accounting.

The percentage-of-completion, roughly speaking, requires that a contractor estimate the profit that he will make on a contract and, bear in mind, he must estimate if he cannot determine it for a certainty—he is required to estimate the amount of profit he holds or expects to make from a given contract. Against that he places the contract price

of the job and, by that method, he determines the percentage of profit that [17] he hopes to make on the contract. With the percentage established by this estimating method, he then, at the end of a given tax year, when the contract is not completed, determines the percentage of completion of the contract. That is to say, he would have to determine, by some recognized method, the percentage of completion of a contract as a whole, that is, the whole structure, for example, how much of the steel work was completed and how much of the cement work was completed, and how much of this and so on. It requires a determination of the percentage of completion of a building, for instance, and that fixes the ratio of profit, and that profit can be reflected, naturally, in the proportion that the percentage of profit bears to the part constructed. That is, roughly speaking, the formula which permits that method to be employed, and when it is adopted by a contractor he must adopt the formula which is laid down for him, and I want to read that to your Honor because it is going to have a very important bearing upon this case.

I am now reading from Regulation 101 in effect under the Revenue Act of 1938 and will presently read to your Honor from the subsequent regulations. That regulation is No. 42-3(a), and it says "Gross income derived from such contracts may be reported upon the basis of percentage of completion." The courts have held that was merely permissive and not compulsory.

“In such cases there should accompany the return certificates of architects or engineers showing the percentage of [18] completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning of the taxable period for use in connection with the work under the contract but not yet so supplied.”

There is the ritual which the Commissioner sets out for anyone who wants to avail himself of the option to adopt the percentage - of - completion method of accounting, but we concede we did not follow that ritual from 1939 on down because we had not adopted that method. We were on the accrual method and, therefore, were not obliged to follow this ritual, but here is a very significant provision in that regulation: “If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.”

Under that provision should it develop that the income as reported did not clearly reflect the income for the year or years involved, then the contractor will re-audit the entire business and arrive at the true income. That provision was eliminated from the regulations. It is not to be found in the regulations which became applicable to the years beginning December 31, 1941.

The ritual for keeping the account is exactly the [19] same but that is just the part which permitted the use of the information obtained upon completion of the contract for the purpose of revising the figures, but that part was eliminated. It was the only instance in the Revenue Act where such information was permitted to be used for the purpose of revising an earlier return, but it was eliminated.

The reason I emphasize these things is this, that when the Revenue Agent came to the conclusion, for reasons which we will presently point out, that we had no right to use the accrual method of accounting—and then, in an alternative determination, if we did have the right to use it, it was not adequate and did not clearly reflect the income—he set about to adopt a method of his own posthumously in 1944; he set out to adopt a method of his own for redetermining the income for 1941, 1942, 1943 and 1944, and, when he did that, he adopted a hybrid method of accounting, for one purpose, namely, to determine the amount of income on the basis of the amount of completion, the percentage, which he ascertained, he adopted the figures on income as we set them out in our accounting method and in our return. He did not question them. He adopted them and used them, so he took, in part, at least, the accrual method which we used, and he says in his report that we did use the accrual method.

He then, for the purpose of determining the percentage of profit to be applied, adopted the

completed-contract method. [20] He looks to the ultimate result as it was ascertained in 1944 and he determines that we made so much profit from each of these contracts. At that time it was a known fact, had become a known fact. He used that basis for the purpose of determining what our profit from these contracts was. When he did that, he did the very thing which was eliminated, which might have been permissible under Regulation 101, but which was no longer permissible, when he attempted to adopt that theory; in other words, to take the completion of contract information and use that for the purpose of determining the basis for the purpose of determining the percentage of profit.

Then he adopted a third method. He introduced and used in connection with that a third method, namely, the percentage-of-completion method by which he determines the amount of profit as related to the percentage of completion of the contract. So, we have this hybrid system of accounting by which he arrives at his determination in this case, which was not only prohibited by the Revenue Act in the elimination of this regulation, but decisions which we will call to your Honor's attention equally frowned upon it and prohibited it and condemned it.

Now, we say that was an arbitrary method employed, one that did not have any justification in law or in fact and, being arbitrary, whatever presumption of correctness there attaches to a Commissioner's report immediately falls, when it

[21] becomes apparent to the Court that an unjustified method was employed; that presumption of correctness then falls, and there is nothing upon which to justify the assessment as made, and it becomes an unlawful assessment.

The Court: When did he pay the money?

Mr. Bischoff: The money was paid in 1945, after the Revenue Agent's reports were made. As I have pointed out, the tax was assessed and we paid it. When we received a refund of \$6500, we were required to file a claim, but in that claim we made the specific provision that it was being done under compulsion. The language of it will be before your Honor.

Your Honor will recall in the case of the United States Supreme Court laid down the doctrine that, when it becomes apparent to the Court that a method or system was employed by the Commissioner in determining a deficiency which had no legal foundation in law or in fact, the deficiency assessed upon it must fall; it is not necessary then for the taxpayer to go on and establish what the deficiency ought to be, or that it ought to be something else.

The Court: When did you sue?

Mr. Bischoff: I beg your Honor's pardon?

The Court: When did you sue?

Mr. Bischoff: We sued in 1946, in early 1946, your Honor. This case has been pending a long time. We sued shortly after payment was made.

The Court: Was there an offer to compromise?

Mr. Bischoff: One of the reasons for the long

time in the case coming to trial is that there were negotiations for compromise, which did not materialize, although they thought they would come to an understanding.

As I stated to your Honor earlier, the crucial question you will have to decide is the meaning of this term "clearly reflect the income." When your Honor reads the Revenue Agent's report, you will see that he construed that language to mean that the accounting method must clearly reflect the income for any given year. In other words, one year needs in itself to be taken out by itself. You will see that he construed that to mean that the accounting method had to clearly reflect the income in that one year, and his whole criticism of our accounting method is predicated, in large measure, if not almost entirely, upon the proposition that the method we employed does not clearly reflect the income.

The Court: Why was it necessary for you in the beginning to ask for permission to change your method?

Mr. Bischoff: The statute requires permission. If your Honor will recall, Mr. Hammond, individually, not the corporation, was on a cash basis prior to 1938. When he dissolved the corporation and was going to continue the contracting business in his own name, he wanted to be on the accrual method. I will comment on that in a minute. [23]

Since he was himself on a cash basis, he was not permitted to make the change to an accrual basis without obtaining permission from the Com-

missioner. That is the regulation, and, so, pursuant to that, he applied for permission and got it.

One of the reasons why it was claimed we were not authorized to use the accrual method is that in 1938 he had reported the balance of the State Capitol contract on the percentage-of-completion basis. He was performing that contract individually, not as a corporation.

Having reported in 1938 on that basis, they say that we were compelled, therefore, to continue on that basis and that we could not change it, but we did have permission of the Commissioner to change it.

What actually happened was that, while we had permission to use the accrual method in 1938, the return was made—so it is claimed here—on the percentage-of-completion basis to be consistent with the first part of the contract, because we could not report a part of the contract on one basis and the balance of the contract on the other. We are required to be consistent, but our contention is in that respect that, even if there had been a deliberate violation of that permission in 1938, which was to use the accrual method in reporting the balance—that using the percentage-of-completion method, as we did, instead of the accrual method, which we were permitted [24] to use, assuming that we either mistakenly did so or even intentionally did so, that would not preclude us from obeying the law thereafter, beginning with 1939, because the only permission we ever had was to go on the accrual basis so, in 1938, assuming that the method

of reporting income for that year was not the accrual method, on the accrual method, we certainly were legally obligated to pursue the legal method, the legal method being the method which the Commissioner permitted us to use and, having permitted us to use the accrual method, we could not use any other. Upon that narrow ground that, because we violated the law in 1938, we should have continued to violate the law continuously thereafter—

The Court: How did you happen to violate it in 1938?

Mr. Bischoff: I have tried to explain that. We do not say it was a violation. I was just using that term hypothetically. Your Honor will recall in 1938 the only contract being performed was the State Capitol. It was the completion of a contract begun by the corporation in the preceding year. In the preceding year the corporation had reported upon a percentage-of-completion basis so, when the balance of the contract had to be reported, they were in a quandry. Should they report the income on the percentage-of-completion basis to be consistent or should they adopt the accrual method, which would have been inconsistent?

They took counsel, and they were advised they would have to be consistent because they could not reflect the true [25] income with respect to the contract otherwise. Even under the most extreme view, if we had violated the law in that respect, that year, or had mistakenly used that system in that year, we would not be legally bound

to continue a mistake or a law violation thereafter. That is our view about that particular phase of it.

They go on to say that, assuming we did have permission, we did not carry our accounting on an accrual basis, an actual accrual basis and, frankly, your Honor, I have not been able to ascertain from the Revenue Agent's report why that method was not an accrual method. Perhaps a statement from counsel here will enlighten us and clarify that issue. We have the books in court and the accountants who kept them and the accountants who examined them and they will testify that the accrual system was adopted and carried out in every respect.

In that same connection, I should point out to your Honor that, when the decisions speak of the adoption of a method, generally the method is that errors that occur in the normal carrying on of accounting do not determine that the method is improper or that the method was improperly adopted or used. Errors are adjusted. If, for example, an item of several thousand dollars was erroneously accrued in one year and should have been accrued in a subsequent year, that can be adjusted, but it does not change or affect the method.

In a very recent case, which I think will be controlling [26] in this case, the case of Security Flouring Mills Company against the Commissioner, the Supreme Court opinion set at rest, once and for all, all controversy as to the meaning of this

term "clearly reflect the income", and they said, in unmistakable terms, that it does not mean that it must "clearly reflect the income" in a given year, but it must clearly reflect the income over the period of years during which a contract is being performed.

The Supreme Court also points out that both the cash and accrual methods have certain deficiencies, because they said in every business enterprise it happens at the end of a year that certain moneys that should have been received had not been received, or, in some years, some accounts that should have been accrued have not been accrued. There is always a hangover by reason of certain bills not having been received, or whatever the case may be and, as a result, certain matters are carried over from one year into the other, whatever system is employed and errors resulting from that condition do not mitigate against the adoption of one or the other method. Whatever errors may creep into accounting, through human frailty, are subject to adjustment.

The Court: Shall I hear from Mr. Winter now?

Mr. Bischoff: I think I have about stated our position.

Mr. Winter: There is one further issue.

Mr. Bischoff: I am sorry. There is one other issue in [27] the case which is unrelated to the method of accounting, and that is whether a partnership existed in the two years under consideration, in 1942 and 1943, between Ross B. Hammond,

the plaintiff, and his son, William A. Hammond. A definite issue is raised as to that, and it is claimed that there was no partnership in reality, although there was a partnership agreement.

With respect to that particular issue, they point out that there was absent all the usual indicia of partnership; for example, the partnership is not disclosed to those persons to whom the existence of a partnership would normally be disclosed, as, for example, the banker, the business associates, that is, some men that they had on a profit-sharing basis, and it was not disclosed to the bonding company, and the contracts were taken in the name of Ross B. Hammond, individually.

A great many circumstances of that kind are pointed out in the Revenue Agent's report which, it is claimed, shows that there was no partnership in fact in existence, notwithstanding the fact there was a written partnership agreement.

There is but one answer to all of the criticism of that partnership, and that is this: The intention of Mr. Ross B. Hammond and his son, William A. Hammond, to enter into partnership in the construction business was present for many years; from the earliest time that the boy was going to school it was contemplated that he was to become interested with his father [28] in the contracting business, as a partner. His education was channeled in that direction, by his training as an engineer, and everything else was directed to that end. It had been the subject of family discussions for years, but when it came time to actually

put that arrangement into operation Ross B. Hammond found himself in a very embarrassing situation.

Ross B. Hammond had at the time—and this was in 1942, in the middle of the war, when important help was hard to get. He had in his employ two men, Petersen and Mason, who had been with him for many years. They had grown up in the contracting business and had become his right and left arms and hands. They were the men who carried on the physical construction of buildings for him, became invaluable to him, and unreplaceable at that time and even at other times.

These two men were clamoring for a partnership. He did not want to make them partners for reasons of his own. He was not averse to giving them adequate profit-sharing agreements but he did not want to make them partners, preferring that whatever business he had should remain in the family and, so, when the conclusion was reached to make the boy a partner, there were these two men. He had to tell them that he did not want to have any partners but wanted to be a lone operator; on the other hand, he wanted his son in partnership with him, so he had to keep secret from these two men the partnership agreement.

The partnership agreement with his son was made on [29] the same date as the written profit-sharing agreements were entered into with these two men. These two men had had very large responsibilities there which enabled them to know all of

the details of the business. They signed checks; they negotiated purchases and sales and did many of the things that Mr. Hammond did himself, and it was necessary for him to conceal from them—not only not to tell them he was taking the son into partnership but he had to conceal from them the sources of information that they might have access to.

It happened that the father-in-law of one of these men, Mr. Mason, was an officer in a bank with which Ross B. Hammond did business, and he knew that if he made a change in the bank account that information would immediately be communicated to Mason and he would become aware of it and there would be trouble.

Then there were other problems that intervened. We were at war. It was necessary to do things in a hurry. Part of that time Bill Hammond was in the Army; part of the time he was out of the Army. There was a question of his eligibility and his physical disability and, in making contracts and carrying out large orders where there were various papers that had to be signed, if Bill Hammond was a member of the partnership and the contract had been taken in the name of the partnership, it would have been necessary to have the son's signature to all of those papers. Practically all of the contracts were with [30] the Government. It would have been impossible to get his signature on some papers and there would be delays, interminable delays. Then there was the question of obtaining bonds, the very lifeblood of a contractor.

The lifeblood of a contractor is ability to obtain bonds for his contracts. He had to maintain that relationship with the bonding company. He was advised by a representative of the bonding company with whom he did business that it would not be desirable, because of Bill's military obligations, for him to be a member of the partnership, because he would have to sign contracts, he would have to sign bonds, he would have to sign documents relating to contracts, if there were cancellations or modifications and what not.

Therefore, to avoid these complications during the war, the existence of the partnership was kept secret, but, as between themselves, they had a written contract, and they made their adjustments on a partnership basis. Securities, however, were purchased in the name of Ross B. Hammond, but they were discussed between them, and, in every sense, as between them, they had a true and bona fide partnership. Ultimately the information was divulged to Mason and Petersen and the need for secrecy was eliminated, especially after Bill was finally discharged from the Army by reason of disability, and then, of course, the partnership was made known and an assumed name certificate was filed.

The law, as we know, has recognized secret partners. [31] There are many instances in which men with capital want to make investments in a partnership but, for reasons of their own, require their identity to be unknown. Simply because they keep that partnership agreement secret between themselves would not affect their legal relation-

ship or prevent a partnership liability to accrue as against a secret partner.

For example, if the Government would seek to enforce a tax liability, they would not have hesitated to proceed against William Hammond as a partner, notwithstanding the fact that the partnership had been kept a secret during that time. They would have asserted their liability, whether the partnership was secret or open.

We can realize, of course, that in a normal case there are certain pertinent circumstances which militate against a secret partnership, but where there is reason for that secrecy and where it is in good faith, then your Honor will have to conclude that the absence of an acknowledged partnership is not significant and will not militate against the existence of a partnership.

Mr. Winter: Turning to the second issue first, it is true, as counsel has suggested, that this was to be a most secret partnership. As a matter of fact, it was not until 1944 that any partnership returns were made. The partnership was even unknown to the accountant and bookkeeper for Mr. Hammond.

On the same date that this alleged partnership agreement [32] was entered into, the son, just recently back, executed a power of attorney to his father. The partnership agreement speaks of \$7500, which was the salary paid to him prior to the formation of the partnership.

It is our position, of course, that the son did not contribute any more service or contribute any

more than the salary which he was to be paid, \$7500; that there was no consideration for the partnership agreement other than a gift from the father, and it is our position that the partnership was invalid, so far as income tax purposes are concerned.

With respect to the first issue: This is not the first time Mr. Hammond or his corporation has had difficulty or been before the Court with respect to this accounting practice.

Prior to December 30, 1937, Mr. Hammond operated in the form of a corporation. Prior to 1933 the corporation kept its books and reported its income upon the completed-contract basis. In other words, they waited until the end of the contract had been completed, and the profit was then reported. Without securing the consent or permission of the Commissioner, after 1933 they reported and prepared the returns on the percentage-of-completion basis. The Commissioner denied them the right to so report, not having secured the prior permission and consent, and he went to the United States Tax Court, then the Board of Tax Appeals, and they said he could not change the [33] basis.

As of December 31, 1938, the Commissioner did authorize Mr. Hammond to report his tax on an accrual basis. When the matter was investigated by the Internal Revenue Department, while the books were purportedly kept on an accrual basis, nevertheless the contracts and returns were on a percentage-of-completion basis, or a hybrid basis. It was not an accrual basis nor was it a true percentage-of-completion basis.

For example, if the Court please, there was no inventory or no consideration, as required by the Regulations, given to work which had not been completed but was in process as of the end of the year, nor to equipment or material which had been accrued on the books.

Because their accounts did not clearly reflect the income, it was necessary for the Commissioner to "recap" or readjust the report so that it did clearly reflect the income for the particular year.

For example, the taxpayer had a contract for the Troutdale Aluminum Plant, what is known as Contract No. 208. In 1941, the taxpayer reported income received of some \$59,000 and showed a profit of \$23,844.25; in other words, almost 50 per cent profit in that one year on that contract. Coming to the next year, although the taxpayer shows income received of \$1,036,522.10, he shows a loss of \$20,786.73, so the only supposition is, if the Court please, that during the year 1942 [34] there must have been a great deal of uncompleted work for which they could not bill the Government in connection with that contract.

Taking the next year, 1943, instead of \$1,000,000 income, they show \$274,431.59 and they show a profit as per their books of \$93,936.62.

No inventory was taken as to how much material was on hand on any particular job at the end of the year, and the regulations specifically say that must be taken into consideration. It clearly appears that the method of accounting and the returns did not clearly reflect the income and the Commissioner

is authorized, by the statute and regulations, to adopt a method which, in his opinion, more clearly reflects the income.

The burden is upon the plaintiff to show that his books and records and returns clearly reflect the income.

The accounts in connection with the Troutdale Aluminum Plant present the most glaring example of distortion of income. All the rest of them show substantially the same but not in quite as large a percentage. No consideration was given to any materials which had been ordered and which were on the job at the end of the year. There is no way for us to go back six or seven years, now, and show what amount of materials was on hand or what percentage of the contracts was completed on a given date.

There is one other matter, your Honor. There is no [35] issue as to the gross receipts from all of these construction contracts. We do deny the plaintiff has reported his full income, what he has accrued. The burden is upon him, however, to show that he has overpaid the tax and that he has taken proper deductions and credits. The record will show that in arriving at the partnership income there was deducted, as an accrual, some \$86,635 in 1942 and \$77,360.30 for the year 1943. That arises under these facts, if the Court please:

Mr. Mason and Mr. Petersen, plaintiff's employees, were key employees and Mr. Hammond's managers of his construction contracts. They did not know about the partnership agreement. They

have agreements with Ross B. Hammond, doing business as Ross B. Hammond Co., and not with the partnership, although the agreement is purported to have been executed on the same date as the partnership agreement with the boy. Yet, it makes no reference to the partnership and, as explained by counsel, it was intended that no one would know about the partnership except Mr. Hammond and his son.

Under these agreements, Mr. Hammond, as sole proprietor, agreed: "The first party hereby agrees that he will pay for the services of the second party by permitting him to participate in the net profits of the operation of first party's construction business upon the basis of fifteen per cent of the profits earned each calendar year, after all operating, financing, administrative, and other like expenses [36] have been deducted, but before deduction of State and Federal income taxes."

Petersen was permitted to draw only \$7500, which was his usual salary. The other man, Mason, had \$10,000. However, under the agreements they were required to leave the balance in the business, and only in the event that they left the employ, and under certain terms and conditions, could they ever withdraw this profit, which was going into the business. In other words, it is our position that at no time did they have the right to receive payment of that money and, therefore, it was not properly accrued as an item of expense on the books and, therefore, that is additional income. I believe the burden is on the plaintiff to show that

he did not receive that additional income. Otherwise plaintiff is not entitled to recover in this case. I think that explains our position on that, if the Court please.

Mr. Bischoff: May I make one or two observations with respect to the matter now suggested so that your Honor will know our views?

First, let me state to your Honor that I do not quite understand the reference to Mr. Hammond's prior tax troubles. Counsel knows that the only sin Mr. Hammond was guilty of in that case was the technical one of not having obtained permission from the Commissioner to change the method of accounting. They were going to make a change in the method of accounting and they felt they had a right to do that without having permission. [37] It was not determined that he was actually guilty of any wrongdoing. In fact, at that time it was a question of a bad method of accounting, because we did not know the requirements, that permission had to be obtained. They were saddled with a tax liability and that was the sin committed, and that was the tax trouble that counsel wants your Honor to have in mind so your Honor would be prejudiced against Mr. Hammond by reason of this prior tax trouble.

We tried to avoid that sin in this case, because when we made the change-over, dissolving the corporation, and Mr. Hammond went on a cash basis; and he wanted to go on an accrual basis, and we applied for permission and got it. That was the sin involved.

With respect to the charge that is now made, and that is not set forth in the Revenue Agent's report, that we understated our income by reason of the credit which was given to the profit-sharing agreements to Mason and Petersen: He tells us that in those two years we accrued that, not as income but as a deduction. He says we understated our income. There is no question of income involved. We took as a deduction the share of the profits which these two men became entitled to under their agreements. It was only accrued on our books. Nevertheless, we had to credit Mason and Petersen with that profit in those years because, under our contracts with them, we had to determine their profit on the same basis as Mr. Hammond [38] kept his books so, having become liable to them by virtue of the contracts for the share of profit to be determined according to how these books were kept, having become liable, it became a deduction; we were compelled to accrue it in that year. So far as deductions are concerned, it is an obligation to pay, and if we had not accrued those two items in those two years, we would forever have been barred from getting the benefit of that deduction.

The Court: Did you pay those amounts?

Mr. Bischoff: One man has been paid in full and one man has been paid off partially, almost in full.

Mr. Winter: Was that in stock of the corporation?

Mr. Bischoff: No, in money, in hard cash.

Mr. Winter: They do not report it here.

Mr. Bischoff: They were not obliged to report it last year, because these men were not on the accrual basis. They were on a cash basis. They reported it when they got it, but we were compelled to report it as a deduction in the year when we became obligated for it.

Counsel mentioned something about failure to keep an account of materials on hand and of expenditures made during a given year. Under the accrual method, your Honor, that would have nothing to do with the reporting of profit and the question of loss in a given year, because it is only the right to receive that accrues income to us—not when we received it. [39]

We may spend, in a given year, \$100,000 towards the performance of a contract but if, under the contract, we are not entitled to receive payment of that \$100,000, by reason of some contractual provision which defers payment to some other time, the liability has accrued then, **your Honor**. We have got to report it under the decisions and under the Act in the year in which it became an account receivable and billed as such.

Your Honor is familiar with Government contracts and with the fact that they contain a provision for monthly estimates; they contain extensive provisions as to how the monthly estimates are to be arrived at. They have to be certified by the engineer.

When that is done, our right to receive that payment has accrued, regardless of when the Gov-

ernment sees fit to pay us. Sometimes the Government pays very soon after the monthly estimates are made and sometimes, because of the red tape in governmental operation, it takes three months or more to get a payment, but the right to receive the payment accrued under the contract when the engineer approved the monthly estimate. That is why we had to set it up on the books on the accrual system. We could not do it in any other way, so it does not make any difference whether we had any materials. We had to take the deduction in the year in which the liability arose.

Of course, it does unbalance the income in any given year, as the courts point out, but in the end the situation [40] rights itself because, if he takes a deduction for \$100,000 worth of material in the year in which he incurred the liability, he cannot take it in the subsequent year when he actually pays it. On the other hand, if he accrues an account receivable as income in a year when he did not get the money, he cannot take it as income the next year when he actually did receive the money. As the courts point out, including the Supreme Court of the United States, these methods equalize themselves.

Counsel lays some stress upon the failure to keep an account of the inventory and work in progress. He says the regulations require it. I challenge him to submit to your Honor any regulation requiring such accounting under the accrual system pertaining to contract work.

There is a regulation that deals with that, and

that will be called to your Honor's attention. I will call it to your Honor's attention now.

Section 41-3 deals specifically with accounting methods to be employed where the purchase and sale of material is a profit-producing factor, like from merchandising, a grocery store, for instance, to the manufacture of lumber and so forth. Here is what it says:

"In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be [41] taken at the beginning and end of the year and used in computing the net income of the year."

There is the regulation and, by its very terms, is limited to that kind of taxpayer, namely, one who is buying and selling merchandise, manufacturing merchandise for sale, and so forth. A contractor is not in that class. A contractor does not sell cement; a contractor does not sell steel; a contractor does not sell wire and the other materials which go into the building of a building; and, when he is on an accrual basis, it does not make any difference how much merchandise he has got on hand. The pertinent and relevant fact is: How much of an obligation have you incurred in the purchase of merchandise and materials? If you have incurred an obligation, you must take it as a deduction in the year in which you incurred it. If you have used that merchandise to a point where you are entitled to be reimbursed for it by the owner, you can bill him with the absolute right

to demand payment, and you must accrue it as revenue or as income that year. It does not make any difference how much extra or excess material there may be on hand.

I want to take sharp issue with counsel when he says we had accrued on our books as income moneys expended for merchandise and materials that had not been used up so we could not render a bill for it. If we could not render a bill, we could not accrue the item because we had no right to receive [42] payment, and that is the basis of income, the right to receive. If the contract says we are entitled to payment when a building, for instance, is completed, we cannot be paid when it is only partially completed. There can never be an accrual in any case where we have not the absolute right to render a bill with the expectation and the right to receive payment.

I think those are the issues that have been raised, challenging our accrual method, your Honor.

Mr. Winter: They say they are on an accrual basis but, if so, the income has to be accrued as the statute and regulations say. If the method which the taxpayer uses does not clearly reflect income, he must use a method which does clearly reflect income. By this method they have not done so.

Counsel has now admitted that there is a great distortion of income. All the Commissioner did was to set up the records so that they could report on a percentage-of-completion basis, percentage of the profit to the costs which were expended, and that is the only fair and the only reasonable method

which could be adopted under the circumstances.

The Court: Suppose we recess now, and then you gentlemen come back at 2:30 to mark your exhibits.

(Recess.) [43]

The pre-trial conference in the above-entitled cause was resumed at 2:30 o'clock p.m., Monday, January 12, 1948.

Pre-trial Exhibits were thereupon marked as follows:

PLAINTIFF'S PRE-TRIAL EXHIBITS

Mr. Bischoff: I offer in evidence, as Plaintiff's Pre-trial Exhibit No. 1, letter dated July 7, 1938, from the office of the Commissioner of Internal Revenue to Ross B. Hammond, signed "Milton E. Carter, Acting Commissioner", granting permission to adopt the accrual method of accounting beginning with the taxable year ending December 31, 1938.

(Letter dated July 7, 1938, Commissioner of Internal Revenue to Ross B. Hammond, thereupon marked Plaintiff's Pre-trial Exhibit No. 1.)

Mr. Bischoff: I offer as Plaintiff's Pre-trial Exhibit No. 2 bill of sale, from Ross B. Hammond to William A. Hammond, of 25 per cent undivided interest in the business of Ross B. Hammond Co., dated February 3, 1942.

(Bill of Sale, R. B. Hammond to William A. Hammond, dated February 3, 1942, thereupon marked Plaintiff's Pre-trial Exhibit No. 2.)

Mr. Winter: We admit the execution of the instrument but deny that it has any legal effect; and it is not binding on the United States or the defendant Collector. [44]

Mr. Bischoff: I offer as Plaintiff's Pre-trial Exhibit No. 3 contract or agreement and articles of partnership between Ross B. Hammond and William A. Hammond, dated February 3, 1942, being the partnership agreement between the parties.

Mr. Winter: We admit the execution of the agreement but as to whether or not it was executed on the date it bears we insist on strict proof and object to it; it is not binding on the United States or the defendant Collector.

(Agreement and Articles of Partnership dated February 3, 1942, between Ross B. Hammond and William A. Hammond thereupon marked Plaintiff's Pre-trial Exhibit No. 3.)

Mr. Bischoff: I offer as Plaintiff's Pre-trial Exhibit No. 4 agreement between Ross B. Hammond, doing business as Ross B. Hammond Co., and Henry Mason, dated February 3, 1942.

Mr. Winter: We have no objection.

(Agreement dated February 3, 1942, between Ross B. Hammond and Henry M. Mason, thereupon marked Plaintiff's Pre-trial Exhibit No. 4.)

Mr. Bischoff: I offer as Plaintiff's Pre-trial Exhibit No. 5 agreement between Ross B. Hammond and A. V. Petersen, dated February 3, 1942.

Mr. Winter: No objection.

(Agreement dated February 3, 1942, between Ross B. Hammond and A. V. Petersen thereupon [45] marked Plaintiff's Pre-trial Exhibit No. 5.)

Mr. Bischoff: I call for the production of original income tax returns of Ross B. Hammond for the tax years 1938 to 1944, inclusive.

Mr. Winter: You realize that these cannot be left in court. They cannot be out of the hands of the Commissioner. I have them here right now, but copies will have to be substituted for the originals.

Mr. Bischoff: It will be agreeable to the plaintiff that the defendant may substitute photostatic copies of the returns in lieu of the originals.

(Plaintiff's Pre-trial Exhibit No. 6 reserved for income tax returns of Ross B. Hammond for the years 1938 to 1944, inclusive.)

Mr. Bischoff: May we stipulate that we may, for the time being, use the retained copy, the taxpayer's retained copy for the year 1944, with the understanding that you will supply a photostatic copy of the original before the close of the trial or while the Court has the case under advisement?

Mr. Winter: I haven't any objection to using your copy.

Mr. Bischoff: We have another copy for our use.

Mr. Winter: If you will put it in there, I will have it photostated, and we will have that done also.

Mr. Bischoff: All right. I will lend you now the taxpayer's [46] retained copy of the 1944 return, and that may now, for the present, be used in lieu of the original, with permission to the Government to substitute a photostatic copy, a certified copy.

Mr. Winter: A photostatic copy. It does not have to be certified. The only objection is that it is incompetent, irrelevant and immaterial.

Mr. Bischoff: I call for the production of the partnership returns for the years 1942 to 1944, inclusive.

Mr. Winter: I only have the returns for 1942 and 1943. Have you got a copy of the 1944 return?

Mr. Bischoff: I have a copy of the 1944 return.

Mr. Winter: We will have it photostated, the same as the other.

Mr. Bischoff: We will stipulate that plaintiff's retained copy may, for the present, be used in lieu of the original, with the understanding that the defendant will cause a photostatic copy to be substituted for the retained copy and the retained copy returned to the plaintiff.

I offer in evidence as Plaintiff's Pre-trial Exhibit No. 7 the partnership return for the years 1942, 1943 and 1944.

Mr. Winter: We have no objection to the returns, as such, having been filed, but we deny that the partnership did in fact exist. However, we admit that the returns were filed with the Collector as shown thereon. [47]

(Plaintiff's Pre-trial Exhibit No. 7 reserved for partnership income tax returns for the years 1942, 1943 and 1944.)

Mr. Bischoff: I call for the production of the returns of William A. Hammond for the years 1942, 1943 and 1944.

Mr. Winter: I have those.

Mr. Bischoff: We can make the same stipulation as to photostating?

Mr. Winter: Yes.

Mr. Bischoff: I offer as Plaintiff's Pre-trial Exhibit No. 8 the individual income tax returns of William A. Hammond for the years 1942, 1943 and 1944. Is there any objection?

Mr. Winter: No objection except that they are incompetent, irrelevant and immaterial to any issue in this case.

(Plaintiff's Pre-trial Exhibit No. 8 reserved for individual income tax returns of William A. Hammond for the years 1942, 1943 and 1944.)

Mr. Bischoff: I call for the production of the assessment of the tax deficiency made for the years 1938 to 1943, inclusive, and covering payments representing the assessment which is the subject matter of this litigation.

Mr. Winter: We have here, Mr. Bischoff, the certificate of the Collector certifying the assessment and payments during 1938 through 1943, which includes or shows the assessment for [48] the year 1943, which is the subject of this suit. The other assessments and payments are not material. I don't think any issue has been raised.

Mr. Bischoff: No. I notice, Mr. Winter, on the last page under the year 1943, in the column headed "Paid, abated or credited" there appears an item under date of August 18, 1945, \$6,554.03 credited.

Mr. Winter: Yes.

Mr. Bischoff: Does that represent the refund?

Mr. Winter: That is the refund which was credited that year; credited on the tax liability for 1943. The balance of the assessment or \$150,-592.87 was paid on August 17, 1945, under "Unidentified Account", the reason for that being that the assessment had not been received at the date of that payment.

Mr. Bischoff: In other words, may the record show the actual payment was received prior to August 17, 1945, but was held in abeyance until the application of the payment was determined by the Commissioner and was thereafter entered as of August 17, 1945?

Mr. Winter: No, it was paid on August 17, 1945, in the unidentified account.

Mr. Bischoff: With the understanding that the date appearing on the last item, 8/17/45, represents the date when the payment was made by the plaintiff, it may be stipulated that the certificate offered may be used in lieu of the original assessment [49] and record of payment.

Mr. Winter: Yes. That shows a certificate of the assessments and payment.

Mr. Bischoff: Yes. I now offer this certificate as Plaintiff's Pre-trial Exhibit No. 9.

Mr. Winter: No objection.

(Certificate of Assessments and Payments 1938 to 1943, inclusive, thereupon marked Plaintiff's Pre-trial Exhibit No. 9.)

Mr. Bischoff: I now call for the production of the claim for refund, Form 843, for the sum of \$6,536.10.

Mr. Winter: I have a photostat of that, Mr. Bischoff.

Mr. Bischoff: If you will show it to me.

Mr. Winter: Yes.

Mr. Bischoff: Let the record show that counsel for the defendant is tendering in lieu of the original a photostatic copy of the claim.

Mr. Winter: I have the original here, Mr. Bischoff.

Mr. Bischoff: In lieu of the original.

Mr. Winter: I have the original in court and we are asking leave to substitute a copy. You have no objection?

Mr. Bischoff: I have no objection to the substitution of a copy.

Mr. Winter: Do you want to see the original?

Mr. Bischoff: No; if you will tell me that is a true copy, [50] that will be sufficient, Mr. Winter. Do you want to make that statement?

Mr. Winter: Yes. It is right here. Here is the original.

Mr. Bischoff: We now offer as Plaintiff's Pre-trial Exhibit No. 10 the claim for refund for the sum of \$6,536.10, dated January 16, 1945.

(Photostatic copy of claim for refund, Ross B. Hammond, dated January 16, 1945, in the

amount of \$6,536.10, thereupon marked Plaintiff's Pre-trial Exhibit No. 10.)

Mr. Bischoff: I call for the production of the claim for \$150,592.87, dated August 22, 1945. You have tendered a photostatic copy, Mr. Winter, and I would like to check it with the original.

Mr. Winter: Here is the original right here.

Mr. Bischoff: Let the record show that counsel for the defendant has produced a photostatic copy of the document called for and represents that it is a true copy, and I now offer it as Plaintiff's Pre-trial Exhibit No. 11.

Mr. Winter: No objection.

(Photostatic copy of claim for refund, Ross B. Hammond, dated August 22, 1945, in amount \$150,592.87, thereupon marked Plaintiff's Pre-trial Exhibit No. 11.)

Mr. Winter: The original claim is here in court.

Mr. Bischoff: I now call for the production of the Revenue Agent's reports of the audit of the income tax returns of Ross B. Hammond for the tax year 1938, one being dated January 24, 1940, and the other being dated January 27, 1941.

Mr. Winter: I do not have those. The report was furnished to you. Have you got the report there? I have no objection to using a copy. You have the original, though.

Mr. Bischoff: I don't know whether we got the originals or copies, to tell you the truth, but we have copies, I think.

I offer as Plaintiff's Pre-Trial Exhibit No. 12 the Revenue Agent's report for the tax year 1938, dated January 24, 1940.

Mr. Winter: We object to it except as the Commissioner may have followed the computations. The Revenue Agent's report manifestly is not evidence except to show the basis upon which the Commissioner determined the tax liability.

Mr. Bischoff: Is there any question about the authenticity?

Mr. Winter: No, we admit that it is a report furnished to the taxpayer upon completion of the examination, showing the basis of the Agent's findings which may or may not be accepted by the Commissioner in all respects. It has no value except to show the basis upon which the Commissioner may have acted.

(Revenue Agent's report dated Jan. 24, 1940, addressed to Ross B. Hammond and signed by Internal Revenue Agent in Charge, thereupon [52] marked Plaintiff's Pre-Trial Exhibit No. 12.)

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 13, Revenue Agent's report for the year 1938, dated January 27, 1941.

Mr. Winter: I object to it as incompetent, irrelevant and immaterial, not within any issue in this case.

Mr. Bischoff: Any question about its authenticity?

Mr. Winter: No. It apparently is a report furnished to the taxpayer covering that year.

(Revenue Agent's report dated January 27, 1941, addressed to Ross B. Hammond by Internal Revenue Agent in Charge, for year 1938,

thereupon marked Plaintiff's Pre-Trial Exhibit No. 13.)

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 14 Revenue Agent's report for the tax year 1939, dated January 27, 1941.

Mr. Winter: The same objection as No. 12 and No. 13. It does not appear to be involved in any issue in this case concerning the years here involved and it manifestly is not evidence.

(Revenue Agent's report dated January 27, 1941, addressed to Ross B. Hammond, for 1939, thereupon marked Plaintiff's Pre-Trial Exhibit No. 14.) [53]

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit 15 Revenue Agent's report for the tax year 1939, dated March 1, 1943.

Mr. Winter: The same objection as to Exhibits 11, 12, 13 and 14.

(Revenue Agent's report March 1, 1943, addressed to Ross B. Hammond, 1939, thereupon marked Plaintiff's Pre-Trial Exhibit No. 15.)

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 16 Revenue Agent's report for the tax year 1940, dated June 12, 1941.

Mr. Winter: The same objection as to previous exhibits of this nature.

(Revenue Agent's report dated June 12, 1941, to Ross B. Hammond, for 1940, thereupon marked Plaintiff's Pre-Trial Exhibit No. 16.)

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 17 Revenue Agent's report for the tax year 1940, dated March 1, 1943.

Mr. Winter: The same objection.

(Revenue Agent's report dated March 1, 1943, to Ross B. Hammond, for 1940, thereupon marked Plaintiff's Pre-Trial Exhibit No. 17.)

Mr. Winter: I cannot see the materiality of any of these Revenue Agent's reports covering years that are not involved here.

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 18 Revenue Agent's report for the tax year 1941, dated March 1, 1943.

Mr. Winter: The same objection as to previous exhibits, No. 12 to No. 17, inclusive. I want the further objection to be shown in the record that no tax liability is involved for any of those years, except overpayment for 1941, which was the subject of a separate report.

(Revenue Agent's report dated March 1, 1943, to Ross B. Hammond, for 1941, thereupon marked Plaintiff's Pre-Trial Exhibit No. 18.)

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 19 Revenue Agent's report for the tax year 1941, dated November 6, 1944.

Mr. Winter: We have no objection.

(Revenue Agent's report dated November 6, 1944, to Ross B. Hammond is re over-assessment of \$6,536.10, thereupon marked Plaintiff's Pre-Trial Exhibit No. 19.)

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 20 Revenue Agent's report for the tax year 1943, dated [55] November 6, 1944.

Mr. Winter: No objection.

(Revenue Agent's report dated November 6, 1944, to Ross B. Hammond, in re deficiency \$145,537.77, thereupon marked Plaintiff's Pre-Trial Exhibit No. 20.)

Mr. Bischoff: I offer as Plaintiff's Pre-Trial Exhibit No. 21 a bundle of duplicate original monthly billings made by the plaintiff, described in the Revenue Agent's reports for the tax years 1941 to 1944, inclusive.

Mr. Winter: What is the purpose? How can any good purpose be served in this case by having a big bundle of monthly billings? It is admitted the monthly billings were made. What do you contend for them?

Mr. Bischoff: Do I understand it is admitted that monthly billings were made in the years in question totaling the amounts shown in the Revenue Agent's reports for the years in question?

(Discussion.)

Mr. Winter: There is no issue between us as to the gross receipts. The only issue is whether or not the books clearly reflect the income and the returns clearly reflect the income in the years when it was earned, or whether the income was distorted.

Mr. Bischoff: Let me ask you this question, and it may clarify the whole matter. I am addressing this question to [56] Mr. Winter and to Mr. Williams, the Revenue Agent. Is there going to be any question that we had the right to bill the owners in accordance with the billings that we have here and upon which we accrued the income in these years?

Mr. Williams: There is no question as to your right, no, sir. The contracts provide as to how the billings shall be made.

Mr. Bischoff: If no issue is going to be raised as to our right to bill in any month for the particular amount that we did bill, then these duplicate billings will not be material and I will not offer them in evidence.

Mr. Williams: There is one point in there that you might discuss. Those billings were made on the basis of the engineer's estimates and the estimates were not, in the case of the month of December, for instance, billed up to December 31st.

Mr. Winter: There is no use spending a lot of time. They may be identified in the pre-trial, and then plaintiff may offer them.

Mr. Bischoff: The bills were rendered in accordance with the estimates which were approved for the month in which the bills were rendered. If there is going to be any issue about that, I want to offer these in evidence.

Mr. Winter: You mean you want to have them identified in the pre-trial order. They are not offered in evidence yet.

Mr. Bischoff: I will have them identified and offer them [57] at the trial, but if there will not be any issue on that subject, I do not want to clutter up the record.

Mr. Winter: You may have them identified in the pre-trial because we might want to use them.

(Bundle of duplicate original monthly billings made by plaintiff thereupon marked Plaintiff's Pre-Trial Exhibit No. 21.)

Mr. Winter: There is no objection to them being identified as plaintiff's billings but I want to reserve the right to object to the introduction of them unless they are tied up in some way to any issue in the case.

Mr. Bischoff: May we have at this time a statement from the defendant as to whether the defendant questions the accuracy of the billings upon that basis?

Mr. Winter: We question that the books were so kept that they reflect the true income of the taxpayer during the years 1942 and 1943; that the income was so distorted that 50 per cent profit on some contracts was reported in one year and a big loss on a million-dollar contract in another year. That is our position.

Mr. Bischoff: I will ask Mr. Williams and Mr. Winter specifically with respect to the billings as made. Do you, Mr. Williams, challenge the accuracy of the billings as made for any reason?

Mr. Winter: I don't think you need to answer that. Let [58] him identify his exhibits. We will bring that out at the trial.

Mr. Bischoff: I think we are entitled to an unequivocal answer from you, Mr. Winter. If you don't want——

Mr. Winter: I don't want——

Mr. Bischoff: If you do not want to answer, we can have the Court come in and require you to make a statement.

Mr. Winter: I don't know whether the billings were properly made or not.

Mr. Bischoff: Do you, Mr. Williams?

Mr. Williams: It would be impossible to determine, sir, without examining the billings themselves.

Mr. Bischoff: You did not question them in your report, did you?

Mr. Williams: It was not necessary to, sir.

Mr. Bischoff: All right. I offer as Plaintiff's Pre-Trial Exhibit No. 22 an envelope or bundle containing contracts pursuant to which the work was done, being the contracts described in the Revenue Agent's reports.

Mr. Winter: These are contracts with respect to 1941, 1942, 1943 and 1944?

Mr. Bischoff: Yes.

Mr. Winter: We have no objection.

(Bundle of contracts, referred to in Revenue Agent's reports, thereupon marked Plaintiff's Pre-Trial Exhibit No. 22.) [59]

Mr. Bischoff: Now, we want to offer for purposes of identification two journal books.

(Two journals, Ross B. Hammond Co., thereupon marked Plaintiff's Pre-Trial Exhibit No. 23-A and No. 23-B.)

Mr. Bischoff: I also offer for identification as Plaintiff's Pre-Trial Exhibit No. 24 the trial balance book of the plaintiff.

(Trial balance book of plaintiff, Ross B. Hammond Co., thereupon marked Plaintiff's Pre-Trial Exhibit No. 24.)

Mr. Bischoff: I would like to have the ledger of the plaintiff marked as Plaintiff's Pre-Trial Exhibit No. 25.

(Ledger of plaintiff, Ross B. Hammond, thereupon marked Plaintiff's Pre-Trial Exhibit No. 25.)

Mr. Bischoff: Those are all of the exhibits we have to offer.

DEFENDANT'S PRE-TRIAL EXHIBITS

Mr. Winter: On behalf of the defendant, we will offer the original returns of A. V. Petersen for the years 1942 and 1943.

Mr. Bischoff: Objected to as incompetent, irrelevant and immaterial and on the further ground that any controversy arising out of the receipt of profits by Mason and Petersen is barred by the statute of limitations and on the ground that [60] the controversy with respect thereto has been adjudicated by this court in a prior proceeding.

(Defendant's Pre-Trial Exhibit No. 26 reserved for original income tax returns of A. V. Petersen for 1942 and 1943.)

Mr. Winter: We will offer also the original returns of Henry M. and Elizabeth R. Mason for the years 1942 and 1943 and ask leave to substitute photostatic copies.

Mr. Bischoff: We make the same objection as to the last exhibit.

(Defendant's Pre-Trial Exhibit No. 27 reserved for income tax returns of Henry M. and Elizabeth R. Mason for 1942 and 1943.)

Mr. Bischoff: I wish to inquire in connection with the last exhibits. Have you the income tax returns for Mason and Petersen for the years, 1944, 1945 and 1946 here?

Court reconvened at 10:00 o'clock a.m., January 13, 1948.

Pre-Trial Proceedings (Continued)

Mr. Winter: We did not finish with identifying all the pre-trial exhibits. There are a few exhibits that we want to have marked.

The Court: All right.

Mr. Winter: I have here a letter from the taxpayer to the Commissioner, dated March 3, 1938, the Commissioner's reply of March 29, 1938, the taxpayer's letter to the Commissioner of April 5, 1938, the Commissioner's reply of April 25, 1938, and the taxpayer's letter of May 9, 1938. All of this is correspondence with respect to the granting of permission to report income tax, explaining the entire situation. We will offer these letters as Defendant's Pre-Trial Exhibit No. 28. I might explain to the Court that they are from the original files of the Commissioner of Internal Revenue and I would like leave to substitute photostatic copies of these communications, but they may be used during the trial, of course.

(Letters dated March 3, 1938, taxpayer to Commissioner; March 29, 1938, Commissioner to taxpayer; April 5, 1938, taxpayer to Commissioner; April 25, 1938, Commissioner to taxpayer; and May 9, 1938, taxpayer to Commissioner, [64] thereupon marked Defendant's Pre-Trial Exhibit No. 28.)

Mr. Bischoff: Plaintiff objects to the introduction of this tendered exhibit on the ground that it is incompetent, irrelevant and immaterial. The

only relevant issue is the consent that was given which is the culminating document issued by the Government. The correspondence which preceded it, we deem to be immaterial and just unnecessarily encumbering the record.

The Court: All the exhibits identified on each side will be admitted in evidence, subject to such objections as may have heretofore been stated or may hereafter be stated on the record, prior to final submission of the case.

Mr. Bischoff: I would like to qualify that, if I may, with respect to a few of these exhibits which were identified at the pre-trial conference. I intend to make a formal offer of these, with some qualifications, if your Honor will permit me to do it at this time.

The Court: Let us finish with the identification.

Mr. Bischoff: Very well.

Mr. Winter: We have here the computation made showing the income tax liability of Ross B. Hammond on a basis of 75 per cent of the income of the alleged partnership to Ross B. Hammond, exclusive of any credits to Mason and Petersen.

In other words, it is a computation which would be [65] for the information and guidance of the Court as showing the tax liability.

The Court in this case can find several bases of judgment, in my opinion. One is that the Commissioner did not err in making the accounting of the taxpayer's return as of May 2nd; also, that a partnership did or did not exist; and, third, the

hand about them or as to whether the computations are correct on any basis.

The Court: You will be given time to check them.

Mr. Bischoff: In the second place, your Honor, we object to the exhibit on the ground that the computations are made upon a basis which was not justifiable or permissible under the law or in fact.

Counsel for the defendant has stated the computations were made upon the basis of the disallowance of certain deductions that were taken representing the allocations to Petersen and Mason of their share of the profits in the years 1942 and 1943.

That issue has already been decided by this Court. The question of the allowance or disallowance of these two deductions was raised when the defendant moved in this court for [68] permission to interpose an offset or counterclaim raising the question that these two deductions were disallowed. We opposed the allowance of the filing of the amended answer tendering that counterclaim or offset on the ground that the statute of limitations had run against those items, and they were no longer subject to review for any purpose. The Court sustained our objection and that amended answer was never filed; that is, it was not filed for any purpose and is not now an issue in the case.

An attempt is now being made to drag that issue into this court through the back door, so to speak, by the tender of this computation and by some things that were said during the submission made

to your Honor; and we oppose this evidence and the introduction of any other evidence which will be an attempt to re-litigate that issue.

In other words, there are two basic objections. One is that the items are barred by the statute and the second is that your Honor has already adjudicated that issue.

The Court: It may be marked, subject to the objection.

Mr. Bischoff: Have you a copy of these statements?

Mr. Winter: No, I do not have. I will have copies made, Mr. Bischoff. I am always glad to furnish any copies, but I have not received one copy of any of your exhibits.

Mr. Bischoff: You have had all the exhibits you asked for.

Mr. Winter: I will be glad to make you a copy.

Mr. Bischoff: Very well. [69]

Mr. Winter: I might say, your Honor, along that line that the exhibit is a computation taken from the books and from the returns which are in evidence and it is merely to help the Court. I think the Court can see the computation much clearer than by going through these returns and books and figuring this all out.

Mr. Bischoff: Mr. Winter, in connection with your last statement, was that computation made on the information contained in the books or was the computation made upon the theory assumed by the Revenue Agent?

Mr. Winter: The computation was made from

the books, by disallowing the \$43,000 to Mr. Petersen, as shown on the return, and it taken from the books and from the returns; nothing extraneous.

Mr. Bischoff: Do you now claim that there are any entries in the books showing the disallowance of the Mason and Petersen profit in the two years in question?

Mr. Winter: The books don't show. There was nothing in the journal and we don't see that there was any capital account with Mr. Petersen and Mr. Mason. The books exhibited to us do not show any capital account but show a deduction of that amount as accrued liability and we say, under the contract which is in evidence, that it was not accrued, not an accrued liability, and could not be accrued because there was no right to receive it unless they were partners and they are admittedly not partners. [70]

Mr. Bischoff: In view of counsel's statement, I make the additional objection that it now appears that the document was prepared in part only upon the books and records of the company and in part upon the conclusions of the Revenue Agent as to the proper treatment, having decided for himself questions of law and fact upon which it was predicated.

The Court: It will be admitted subject to objection.

Mr. Winter: Now, then, the power of attorney. Mr. Jacob, you gave to us a copy of the power of attorney. Do you have that power of attorney from William A. Hammond?

Mr. Bischoff: Is that a copy?

Mr. Winter: That is the copy that was given to us.

Mr. Bischoff: If it is a copy, we can stipulate.

Mr. Winter: We will offer as Defendant's Pre-Trial Exhibit No. 30 the power of attorney from William A. Hammond. I understand counsel has no objection. He says it is a copy and, since it is also a part of the official record, we would like to ask leave to withdraw this and make a photostatic copy.

Mr. Bischoff: No objection, your Honor.

(Copy of Power of Attorney, dated February 3, 1942, William A. Hammond to Ross B. Hammond, thereupon marked Defendant's Pre-Trial Exhibit No. 30.)

Mr. Bischoff: As I understand, we are still in pre-trial. In that connection, some question was raised last night during [71] the pre-trial conference, in your Honor's absence, in connection with the introduction of exhibits, that there might be some other records that ought to be here. We caused an examination to be made, and we produce two records upon what might be called the subsidiary ledger account of A. V. Petersen and H. M. Mason. They are a part of a volume which is a subsidiary ledger. It is a looseleaf ledger and we have taken out two pages which represent these accounts. I will ask permission of the Court to do so, without offering the whole book in evidence, because it is currently in use and we know of no reason for the use of any of the other parts of the book

unless counsel on the other side suggests some other parts that might be pertinent. In the absence of that, we will ask to have marked for identification these two ledger accounts of Mason and Petersen.

Mr. Winter: We have no objection to them being marked at this time. However, this is the first time, on pre-trial, that we have ever found out about the existence of this book. In fumbling through it rather hurriedly, I see it only refers, outside of these two ledger sheets which counsel says he took from there and which refer back to 1938—the book apparently, so far as I have been able to find out, does not go back beyond 1945. I think it should be properly identified so that we know what it is. We had not seen it before. I don't know whether it is complete or not.

Mr. Bischoff: There will be further identification, your [72] Honor. My explanation was only with respect to the matter of taking out the two sheets instead of offering the whole book.

There will be evidence as to the system of accounting that they maintained. They kept a separate record for every contract, as they were required to do by certain requirements, and, whenever a job was completed, they took out of this subsidiary ledger all portions of the account dealing with the specific contract, and these pages, dealing with the account, are filed with the record of that particular contract. That explains the absence of a great many pages which would normally be in there.

Mr. Winter: I think, along the same line, we would like to have the entire book identified, because there appears to be a sheet relating to William A. Hammond which does not even appear to be on the same type of paper as shown by the book. I don't know when it was made. It was here just a minute ago. That does not even appear to be on the same type of paper as the other.

Mr. Bischoff: Well, it goes back to 1940, and they were using different pages.

Mr. Winter: No capital account is shown as being set up until 1943.

Mr. Bischoff: We will avoid any question about that by asking that these two pages be marked for identification as Plaintiff's Pre-Trial Exhibit 31 and 32, the sheet pertaining [73] to Petersen being No. 31 and the sheet pertaining to Mason being No. 32. We offer them only for identification at this time, your Honor.

Mr. Winter: Don't you want the sheet pertaining to William A. Hammond identified?

Mr. Bischoff: I don't know. We will see. We might.

(Subsidiary Ledger Account A. V. Petersen thereupon marked Plaintiff's Pre-Trial Exhibit No. 31.)

(Subsidiary Ledger Account H. M. Mason thereupon marked Plaintiff's Pre-Trial Exhibit No. 32.)

Mr. Bischoff: In view of counsel's last statement, with its implication, I am offering for iden-

tification the sheet containing W. A. Hammond's account.

Mr. Winter: I think counsel ought to identify the entire book.

Mr. Bischoff: We are going to offer the whole book.

Mr. Winter: I don't have any objection to doing that except that it is not material.

Mr. Bischoff: I do not want to have any implication left in this case.

(Ledger Account of W. A. Hammond thereupon marked Plaintiff's Pre-Trial Exhibit No. 33.) [74]

Mr. Bischoff: I want to offer then for identification the rest of the subsidiary ledger, which has been the subject of discussion, your Honor.

(Subsidiary Ledger, less Plaintiff's Pre-Trial Exhibits, 31, 32 and 33, thereupon marked Plaintiff's Pre-Trial Exhibit No. 34.)

Mr. Bischoff: We offer also, may it please the Court, a subsidiary account to show the breakdown and allocation of the capital account to the partners.

Mr. Winter: I object to it on the ground it is not properly identified, has not been properly identified. It has not been shown when it was made.

Mr. Bischoff: We are offering it for identification. It will be up to us to prove it.

The Court: It may be marked.

(Sheet from Subsidiary Ledger in re Capital Account thereupon marked Plaintiff's Pre-Trial Exhibit No. 35.)

Mr. Bischoff: I think, your Honor, that closes the pre-trial proceedings.

Mr. Winter: I don't think we have any further documents to be marked. [75]

PROCEEDINGS OF TRIAL

The Court: Now, to save the specific offer of all exhibits, we will do what we usually do in tax cases, receive in evidence all exhibits that have been identified. I don't know whether we are going to run into trouble or not, Mr. Bischoff. I don't know what you had in mind, but you identified two or three exhibits a while ago.

Mr. Bischoff: I will state to your Honor what I have in mind. There are certain exhibits that I want to offer in evidence and certain exhibits that were marked as pre-trial exhibits yesterday that I do not want to offer in evidence. It may become necessary later on but I want to avoid offering them at this time because it probably won't be necessary to encumber the record. They are very voluminous.

The Court: Just call the numbers off, either one way or the other.

Mr. Bischoff: I now offer in evidence the documents and records which were numbered as Plaintiff's Pre-Trial Exhibits 1, 2, 3, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20 and 35.

The Court: They are all admitted subject to such objections as have been heretofore stated or may hereafter be stated prior to final submission of the cause.

Plaintiff's Pre-Trial Exhibits Nos. 1, 2, 3, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, [76] 19, 20 and 35, respectively, were thereupon received in evidence and marked Plaintiff's Exhibits Nos. 1, 2, 3, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20 and 35.)

[Printer's Note]: Plaintiff's Exhibit No. 1 is set out at page 518. Exhibit No. 3 is set out at page 519. Exhibit No. 6 is set out at page 534. Exhibits Nos. 12, 13, 14, 15, 16, 17, 18, 19 and 20 are set out at pages 553-619 of this printed record. Exhibit No. 35 is set out at page 650.

Mr. Bischoff: And we offer for identification only at this time Plaintiff's Pre-Trial Exhibits numbered, respectively, 21, 22, 23, 24 and 25.

The Court: They are admitted for identification.

Mr. Winter: What about 4 and 5?

Mr. Bischoff: I am not offering 4 and 5. You may offer them, if you want to, but I am not going to.

Mr. Winter: The Government will offer Plaintiff's Pre-Trial Exhibits 4 and 5 which were identified at the pre-trial yesterday.

The Court: Admitted.

(Plaintiff's Pre-Trial Exhibits 4 and 5 were thereupon received in evidence and marked Defendant's Exhibits No. 4 and No. 5.)

[Printer's Note]: Plaintiff's Pre-Trial Exhibits Nos. 4 and 5 are set out as Defendant's Exhibits 4 and 5 at pages 525-533.

Mr. Winter: The Government will also offer Defendant's Pre-Trial Exhibits 26 to 30, inclusive. I think that covers all of the exhibits, if the Court please.

The Court: They are admitted.

(Defendant's Pre-Trial Exhibits No. 26 to No. 30, inclusive, thereupon received in evidence and marked Defendant's Exhibits Nos. 26 to No. 30, inclusive.) [77]

[Printer's Note]: Defendant's Exhibits Nos. 26, 27, 28 and 29 are set out at pages 620-647.

Mr. Bischoff: I want to object to the introduction of these exhibits in evidence, may it please the Court, on the ground that it is an attempt to re-litigate an issue which your Honor has already litigated and adjudicated.

The Court: What are you referring to by that?

Mr. Bischoff: All of them being regarding the deduction of the allocation of the profit to Mason and Petersen in the tax year 1943 and 1942, which was adjudicated in connection with the motion of the defendant to file an amended answer tendering a counterclaim or offset based upon these two transactions. Your Honor determined that the items were barred by the statute of limitations and there was an adjudication on that, and they are not now the subject of any issue in this case. We add the further objection that the Revenue Agent's reports upon which this tax assessment was made and

paid did not raise any issue as to the deductibility or the right to deduct these items in computing our income tax for the years in question, and it has no place in this case.

The Court: They are admitted, subject to objection.

The Court: Call a witness. [78]

ROSS B. HAMMOND,

the plaintiff herein, was thereupon produced as a witness in his own behalf, and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. Mr. Hammond, you are the plaintiff in this action? A. I am.

Q. Where do you live?

A. Portland, Oregon.

Q. How old are you? A. Fifty-eight.

Q. How long have you lived in this community?

A. Since 1920.

Q. Prior to that where did you live?

A. Detroit, Michigan.

Q. What is your occupation?

A. Building contractor.

Q. How long have you been engaged in that occupation? A. Since 1910.

Q. Have you followed that business and occupation during all the time you have lived in Oregon?

A. I have.

Q. That is, in Portland, Oregon?

A. I have, yes.

(Testimony of Ross B. Hammond.)

Q. Will you state the nature of the construction work that [79] you do, that is, what kind of construction work?

A. It is almost exclusively building construction.

Q. Can you name some of the buildings that you have constructed in Oregon?

A. Well, we built the north half of the Pittock Block, the Bedell Building, the Pacific Building, quite a number of city schools, the State Capitol and several large——

Q. At Salem?

A. At Salem. Do you want me to stay in Portland?

Q. Just the important ones, yes.

A. We are just finishing the Equitable Building.

Q. Did you build this Federal Courthouse we are in now?

A. I built this, about 90 per cent as a subcontractor; built the Stadium.

Q. That will be sufficient to illustrate the kind of work you are doing. During your operations here, did you operate in your own name as an individual or did you operate during any of the time as a corporation or a partnership?

A. I operated first as a corporation, then as an individual, and now as a partnership.

Q. When was the partnership formed?

A. As I remember, it was in February, 1942; the exact date I am not sure of, I think the 3rd.

(Testimony of Ross B. Hammond.)

Q. I show you Plaintiff's Exhibit No. 2 and ask you if that is your signature on that document?

A. Yes, sir.

Q. Did you execute it on the date it bears?

A. Yes, sir.

Q. Did you deliver that to your son, William A. Hammond, who is named in that document?

A. Yes.

Q. What is that instrument?

A. This is a partnership agreement.

Q. Wait a minute. Look at it carefully.

A. I am sorry. Pardon me.

Q. That is a bill of sale of an interest in your business?

A. That is correct, selling him a 25 per cent interest.

Q. I show you Plaintiff's Exhibit No. 3 and ask you if that bears your signature?

A. Yes, sir.

Q. Was that executed on the date it bears?

A. Yes, sir.

Q. Is your son's signature on there?

A. Yes, sir.

Q. Did he sign it in your presence?

A. I presume so.

Q. Signed in your presence? A. Yes.

Mr. Bischoff: Your Honor, would you care for me to make a brief statement as to the high spots of the instruments? [81]

Plaintiff's Exhibit No. 2 is a bill of sale by which the plaintiff sells to William A. Hammond

(Testimony of Ross B. Hammond.)

a 25 per cent undivided interest in and to all the rights, interests and assets of every kind and character whatsoever now owned and used by the plaintiff in the business done and conducted in the name of Ross B. Hammond Co. I think that is all that need be said about that.

The Court: What is the date?

Mr. Bischoff: February 3, 1942. Plaintiff's Exhibit No. 3 is an instrument entitled "Agreement and Articles of Partnership" and recites that William A. Hammond has directed his studies and education to the end that he might become associated with the company as a member of the firm, and that he has completed his education and qualified himself as an expert construction engineer and has been for some time in the employ of the Ross B. Hammond Company in that capacity; and recites that, after serving a short time in the armed forces, he was rejected from the service; that the company is bidding upon projects and proposes to engage in extensive construction contracts in furtherance of the defense program of the United States; that Ross B. Hammond desires to be relieved of some of the duties and responsibilities of the management of said business and desires to further develop the knowledge and experience of William A. Hammond in the construction field; and it recites the sale to William A. Hammond of a one-fourth interest. [82]

(Testimony of Ross B. Hammond.)

Then, it is agreed that the partnership began on the 3rd day of February, 1942, and shall continue during the joint life of the parties, unless dissolved by action of the parties; and then it describes generally the character of the business that is to be done, where the place of business is to be; and provides for the respective interests in the partnership of 75 per cent to Ross B. Hammond and 25 per cent to William A. Hammond; that the partnership assumes all the liability of Ross B. Hammond Company including liabilities incurred by Ross B. Hammond in the agreements entered into with Mason and Petersen covering their employment upon a profit-sharing basis; and they agree to share the profits and losses upon the basis indicated.

The agreement provides as to the amount of drawings which would be permissible by the partners, Ross B. Hammond being permitted to draw \$22,500 per annum and William A. Hammond \$7500 per annum. It is further agreed that if the total income for any year exceeds \$30,000 the capital shall be permitted to remain in the business, and reciting the reasons therefor—that there is need for working capital to finance large contracts which were in operation.

The Court: Was there ever a corporation?

Mr. Bischoff: I beg your Honor's pardon?

The Court: Was there ever a corporation?

Mr. Bischoff: There was, up to the end of 1937.

(Testimony of Ross B. Hammond.)

The Court: Then he operated as an individual?

Mr. Bischoff: Then the corporation was dissolved as of the end of that year and he operated as an individual.

The Court: And then as partners?

Mr. Bischoff: From that time, your Honor, from January 1, 1938, to the time this partnership was formed, he operated as an individual.

The Court: Was there any other son in the family?

Mr. Bischoff: No. He is the only son. Is that correct? A. That is correct.

Mr. Bischoff: He is the only son. The agreement provides that the partners shall have equal voice in the control of the business and the operation of the partnership.

The Court: What was the son's age?

Mr. Bischoff: Q. Mr. Hammond, how old was your son in 1942, at the beginning of 1942 when the partnership agreement was made?

A. Well, he is thirty now. That would make him twenty-four then.

The Court: Had he finished college?

A. Oh, yes.

The Court: You ask the questions.

Mr. Bischoff: In a moment I will be through with this contract. I intend to ask him all of these questions, if your Honor will permit me.

The provision is further made for the keeping of books [84] and accounts and access to the accounts by both partners. Those are the high spots of these two exhibits, your Honor.

(Testimony of Ross B. Hammond.)

Q. Mr. Hammond, what education did your son, William, get preparatory to carrying on the contracting business?

A. Well, he studied engineering and graduated from Stanford University as a civil engineer.

Q. Can you tell us in what year he graduated from Stanford University?

A. I forget. I will have to get some help from my son.

Q. Give us your own best recollection.

A. It was about 1940. I think it was 1940.

Q. 1940? A. Yes.

Q. Prior to graduation from Stanford what schooling did he have besides the engineering course at Stanford?

A. He graduated from Culver and had gone a couple of years to Washington High School and the public school at Eastmoreland.

Q. Prior to his graduation from Stanford University did your son do any work in connection with your contracting business?

A. He worked summers during vacations with the company, yes, as a laborer.

Q. Over what period of time did he put in any work, working with your company during the school period? A. During the vacations?

Q. Yes. [85]

A. Well, he worked nearly every vacation.

Q. How old was he when he first began to work with you?

A. Oh, he was probably seventeen or eighteen.

(Testimony of Ross B. Hammond.)

Q. Did you have any plans for him with respect to the work he was to engage in, from the time he was a child?

A. I think they started when he was ten.

Q. Tell us what your intentions were and what plans you made for his training and for what occupation? Tell us that without going into too great detail.

A. Well, we had many discussions, his mother and myself, with him over quite a period of time. He wanted to be in the contracting business and, as a matter of fact, we tried to dissuade him but he was going to be in the contracting business.

Q. When you became convinced that was what he wanted, did you do anything towards perfecting him to qualify him for that business?

A. Then we put him through Stanford and during vacations I spent a lot of time trying to develop his construction knowledge, and developed in the same way I would develop and had developed all the rest of the organization.

Q. Will you be a little more specific as to what you had him do from the ground up, so to speak, about learning various phases of the business?

A. I sent him out on the job under a superintendent, as a laborer, and then put him on as a timekeeper; from there, I put [86] him on as an engineer in charge of a job and from then to a superintendent in charge of a job and from then to assistant general superintendent and, of course,

(Testimony of Ross B. Hammond.)

I could train him a whole lot more specifically than I could some of the rest of the boys.

Q. Did you do all that pursuant to a plan that you had for his development in your business?

A. As he expressed it definitely that he was going in the contracting business, I wanted him in business with me, and of course I developed him for that purpose, with his consent, at the time.

Q. This training you were giving him, was that casual or was that intensive training?

Mr. Winter: The last three questions have been very leading. I don't think the witness should be led.

The Court: He may answer. What was the nature of the training?

Mr. Bischoff: Q. What was the nature of the training, whether it was casual or intensive?

A. Very, very intensive and concentrated.

Q. Did you move him along at the same rate as other employees were moved along?

A. Possibly we moved him along much faster with that type of training.

Q. When you were together, then, at home and otherwise, did you discuss **problems of construction** with him? [87]

A. To the extent that we were not very well liked by his mother.

Q. Well, in the early stages of development was there any discussion at home as to his association with you in business?

(Testimony of Ross B. Hammond.)

A. My impression was that he wanted to be on his own; among things, he wanted to go to South America, like all other construction young people do.

Q. What did you do when you learned of that inclination?

A. Put on quite a sales campaign to talk him out of it.

Q. Was that subject a subject of discussion in the family between your wife and William and yourself? A. Yes.

Q. Over what period of time did those discussions continue?

A. Oh, from the time he graduated from Stanford and came to work for us.

Q. When you learned of his inclination to go to South America, what did you do then?

A. All this developed very rapidly and was crystallized with him. The fact he was called into the service changed a lot of plans.

Q. What I am trying to get at, Mr. Hammond is whether the inclination he had to go to South America had anything to do with your ultimate determination to take him into partnership?

A. Very much.

Q. When did you express that intention, then, and what was done in that respect? Ultimately, what was decided upon?

A. Because he was a reserve officer, he finally was taken into [88] the service. He did not get a physical examination here but was sent to Fort

(Testimony of Ross B. Hammond.)

Lewis first and within three or four days—I think the examining officer advised him that he would not be able to stay in the Army but that it would take thirty or sixty days probably get him back out, and that was the first time that we knew that he was going to be out or that he was going to stay out.

At that time I discussed it with his mother and, when he got back, I had crystallized a set of plans to make Bill a partner, if he was willing to be a partner, and make a deal with the other two boys who I was also raising in the construction business.

Q. Those two boys were who?

A. Mr. Petersen and Mr. Mason.

Q. They had been with you for some time?

A. Yes, and gone through the same training that Bill had except a little longer time.

Q. How long before February 3, 1942, was it that Bill was discharged because of disability, approximately?

A. You mean when he was back here or received his discharge? That was only a few days before that. I mean, it was shortly after he got back, actually back into Portland.

Q. That is when you took up this matter of a partnership?

A. Took it up almost immediately.

Q. Are those the discussions that culminated in the making of [89] the agreement, which is Plaintiff's Exhibit No. 3, Exhibits 2 and 3?

A. The agreements with Petersen and Mason?

(Testimony of Ross B. Hammond.)

Q. No, Exhibits No. 2 and No. 3 are the bill of sale and partnership agreements.

A. Yes.

Q. Those are the discussions that culminated in those two instruments? A. Yes.

Q. Just before he went into the Army the first time, will you state the character of work he was doing at that time in connection with your operations?

A. I believe he was the engineer on the Aluminum Plant at Troutdale, in charge of all of the layout and general engineering of that type for all the buildings, which covered quite a territory and he had quite a few engineers under him.

Q. Will you state how the character of the work you were doing after the war started compared with the jobs that you were doing before, in Portland?

A. Well, the jobs were larger and there were many more of them.

Q. In connection with this aluminum job upon which Bill was the engineer, was he in sole charge of that job?

A. No. In fact, he was under Petersen, who was the superintendent in charge of the job.

Q. Who was the chief engineer? [90]

A. Bill was the chief engineer.

Q. And that was the condition when he went into the Army originally?

A. Yes, the first time.

Q. Then he was in there a short space of time and was discharged? A. Yes.

(Testimony of Ross B. Hammond.)

Q. When he came back, this partnership agreement was made? A. That is correct.

Q. What work did you set him to do? What was the nature of his activities after the partnership agreement was made? Were they enlarged any?

A. Very much. As a matter of fact, the conditions had changed into—We had got a big housing project, called University Homes, which took Mason out of the picture; took him clear out. That was one job that was plenty big enough. The activities at the aluminum plant had grown larger, and we had just accumulated another housing project at Guilds Lake. That left me with nobody in the office, so I made Bill general superintendent of the Guilds Lake project and also assistant to me in the office for other work.

Q. Were his responsibilities greatly increased by reason of that change?

A. Well, the Guilds Lake job was, I think, better than a million-and-a-half job of housing in which he was completely in charge and dealt with the Federal Public Housing Authority direct; took [91] care of the supervision of the construction, the collection of the money and the general records that are involved in that type of a transaction.

Q. Did he have anything to do with the making of the bids and submitting of the bids on that job?

A. Well, he helped; as a matter of fact, on a bid of that size, we all sit in, Peterson, Mason, Bill and myself, four of us.

(Testimony of Ross B. Hammond.)

Q. Who did the major part of accumulating the data and prices and so forth to enable a bid to be made?

A. I believe Bill did that on that job.

Q. Did he continue in doing work of that character after the partnership agreement was entered into? A. Oh, yes.

Q. Did he have authority to sign checks?

A. Yes.

Q. Did he have authority to give instructions with respect to the purchase of materials and to make decision with respect to the major aspects of the operation? A. Yes.

Q. How long, then, did he remain in that work before he again went into the Army?

A. I believe that was October of that year, 1942.

Q. Was there any difference of opinion between you and your son with respect to whether he should attempt to get into the Army or continue to work and so on? [92]

A. Yes, very much. I wanted him out of the Army because I believed he could do Uncle Sam more good here than he could in the Army and, after a lot of discussion, he practically told me to run my own business. He had been in the Army—he had two commissions and thought he ought to go.

Q. The operations you were conducting and the partnerships—and the contracts the partnership had, were they Government contracts?

A. I think 100 per cent of them were.

(Testimony of Ross B. Hammond.)

Q. It was your view that he could better serve the war effort by remaining with you?

Mr. Winter: All of counsel's questions are leading and we certainly object to them.

Mr. Bischoff: I will withdraw that question.

Q. State what your views were as to where he could best serve the war effort?

Mr. Winter: We will object to that as calling for a conclusion of the witness, what his views were.

The Court: Answer.

A. Well, he could best serve the same as Petersen and Mason and the rest of the boys were on this work that had to be done before the war started, actually.

Q. Your own knowledge of his physical disability, did that have anything to do with your determination or conclusion?

A. I knew they could never get him out of the country. [93]

Q. Do you know what the nature of his disabilities were?

A. Well, in layman's terms, he had had a mastoid, and they had severed a nerve, I think, and broke the eardrum, so he had a physical defect on the side of his face and he could not hear out of one ear.

Q. Nevertheless, he went into the Army in the latter part of 1942? A. That is correct.

Q. How long did he remain in the Army?

A. I think about four years.

(Testimony of Ross B. Hammond.)

Q. Do you remember when he got out of the Army?

A. I can't remember; about, oh, I think about two—I can add it up; a couple of years ago.

Q. Well, we will have Bill tell that. He will know perhaps better than you can recall it.

A. Yes.

Q. During the time he was in the Army did he go overseas at all? A. No.

Q. Was he discharged by reason of a disability ultimately? A. No.

Q. Did you see Bill at all during the period of time he was in the Army for the second time?

A. Several times.

Q. Did you confer with him in reference to your business affairs or partnership affairs? [94]

A. In detail.

Q. Did you correspond with him in connection with business affairs during the time he was in the Army?

A. Quite a lot, mostly by telephone.

Mr. Winter: This is all leading, it seems to me, if the Court please.

Mr. Bischoff: Q. Mr. Hammond, when you made the partnership agreement with your son in February, 1942, did you disclose the existence of that partnership agreement to anyone?

A. Only to Bill and——

Q. I presume your wife knew of it?

A. Yes. I very probably would do that.

(Testimony of Ross B. Hammond.)

Q. What did you continue to do in the matter of taking contracts for yourself?

A. I took them as an individual.

Q. Now, will you tell the Court why you kept the existence of the partnership between you and your son a secret?

A. Well, Mr. Mason, particularly, had been very aggressive in wanting more and more salary and an interest. I had been trying to satisfy them, and he wanted to be a partner. He wanted to have a proprietary interest in the organization which I definitely did not want. Mr. Petersen was less that way and——

Q. But was he wanting a partnership interest, too?

A. Yes, I think probably being led by Mr. Mason—a proprietary interest or some kind of a deal, either to form a corporation or [95] some way to get a proprietary interest, and we had been talking about it for a long time, a long time before these agreements ever crystallized. I did not dare let him know because, with all of this work coming up——

Q. Let who know?

A. I did not dare let Mason know or Petersen. After all, if you let anybody else know, you let everybody know, and, with all of this work that we had coming up, and with this type of men whom I had trained for ten or fifteen years, I knew, of course, the tendency was for every contractor to reach out and offer some enormous salaries to these

(Testimony of Ross B. Hammond.)

boys, and they were still boys, and I was afraid that they might jump at them.

But I didn't want to do that with Bill; if I was going to get him in, I wanted him in on a proprietary interest, which he agreed was the right thing to do, but I couldn't let them know that because immediately they would have put up a big argument and my agreement with them would have been worthless.

I couldn't tell the bank because Mr. Mason's father-in-law was vice president of the bank that I did business with, so I decided to tell nobody but Bill and his mother. That was the first reason, and then, when he went back in the Army a second time, then there were ten more reasons because he had had the same experience, as you may know, with the Government——

Q. Will you explain what those reasons were?
[96]

A. Every time you make a change order, with a partnership you have to have both signatures and at that time we did not know where Bill might be, and there would have been delay and delay, and red tape and everything under the sun, and that was the reason it was kept that way while he——until after the big rush, the first big rush, was over.

Q. Did you disclose the partnership to your bonding company or to any representative of the bonding company with whom you did business?

A. I believe I told Mr. Thomas of Dooly &

(Testimony of Ross B. Hammond.)

Company who had been handling our bonds for years. I didn't even want to tell him, but I thought there might be some tough bonds coming up and I wanted to be in a position for them to bond us. Well, they never did develop so we never had to put up a bond on this work.

Q. When you disclosed that to Mr. Thomas, what did he tell you?

Mr. Winter: We will object to what Mr. Thomas told him as hearsay, as far as we are concerned.

Mr. Bischoff. Q. Where is Mr. Thomas now?

A. He is on a vacation, I believe.

Q. Do you know where he is?

A. I think in Palm Springs; I am not sure.

Q. Did you withhold the information from your office help, the bookkeeper, for instance?

A. I withheld it from everybody.

Q. Is that the reason why you took the contracts in your own [97] name?

A. I didn't understand.

Q. Are those the reasons you took contracts in your own name, after the partnership was formed?

A. I couldn't, because these contracts were accessible to everybody in the office, particularly these men whom I wanted to keep it away from, because they had to be available, and I had to serve as an individual party in them.

Q. In your contract with your son, the partnership contract, you made a provision for retaining earnings above \$30,000 a year for working capital. Why was that done?

(Testimony of Ross B. Hammond.)

A. In the contracting business it is very important that we have heavy liquid assets because of bonding capacity and because of finance charges—Well, normally, while we are supposed to get paid every month, by the time they come through it is two months or better, but the workmen get paid every payday, and that requires a lot of cash or liquid assets which you can borrow money on at the bank.

Q. At the same time you made the agreement, the partnership agreement, with Bill, you also made two other agreements with Mason and Petersen? A. I did.

Q. Were similar provisions made with respect to retaining the working capital in the business?

A. Yes. I gave them a drawing account. [98]

Mr. Winter: The agreements are the best evidence, if the Court please.

Mr. Bischoff: Q. Mr. Hammond, during the course of the partnership arrangement, after the agreement was made, did you purchase some securities? A. Yes.

Q. With surplus funds? A. Yes.

Q. You bought them from time to time?

A. Yes.

Q. In whose name were those securities purchased? A. Mine.

Q. Were those purchased with firm's funds?

A. Yes.

Q. Why did you purchase those securities in your own name?

(Testimony of Ross B. Hammond.)

A. Well, I purchased them through Dickinson & Jones, bond brokers, and Mr. Jones, when I suggested what I wanted them for and why I was purchasing them—I, of course, wanted to purchase them as a partnership deal and he advised me——

Mr. Winter: We will object to what Mr. Jones advised him, as hearsay.

Mr. Bischoff: Yes.

Q. Were you buying and selling these securities from time to time? A. Yes. [99]

Q. In making sales, you knew you had to endorse the securities? A. Yes.

Q. And did the absence of your son in the service have anything to do with determining how to purchase the securities?

Mr. Winter: We submit that the question is leading and calling for a suggestion—a suggested answer. He can ask him his reason for doing it, but I don't think he can tell him the answer. The question is objected to.

The Court: Why did you buy them in your own name?

A. Because, in transferring them back and forth, as Jones suggested we might have to sell, and, to get the endorsement of Bill, when we would not know where Bill might be and how quick it could be obtained—it would be much simpler to buy them as an individual.

Mr. Bischoff: Q. Did you use these securities as collateral in financing?

(Testimony of Ross B. Hammond.)

A. The bank has \$50,000 of them now. The bank probably would not accept them unless they were endorsed by both.

Q. In other words, if they had been bought in the name of both, it would require the endorsement of both to use them for collateral? A. Yes.

Q. When, for the first time, was any disclosure made of the existence of a partnership between yourself and Bill to anyone outside of the immediate family?

A. When Bill came back from the Army, it was necessary, for [100] some reason, to establish the assumed name, to be published, and, knowing that that was going to be, I told Mr. Petersen. First, I told him and told Mr. Mason a little later on. This was only a couple of years ago.

Q. At that time what was the condition of affairs with respect to the need for secrecy?

A. Well, we were in a lot easier shape to take care of our business. We had developed some more men that could probably be brought up and Bill was back and, well, it wasn't so important whether somebody got mad and walked out.

Q. When you made the disclosure to Petersen, did he express any surprise?

A. Yes. His nationality keeps him from talking very much, being Swede, but he was rather surprised.

Q. Did you tell him the reason why you had kept this a secret from him? A. Yes.

Q. Did he make any issue of the thing after that? A. No.

(Testimony of Ross B. Hammond.)

Q. Did you ultimately inform Mason about it?

A. Yes.

Q. Had you communicated that information to him before you filed the assumed name certificate?

A. I think a short time.

Q. Up to the time that you made the disclosure of the existence [101] of a partnership between you and your son, did you give any instructions about changing the method of bookkeeping that had been theretofore used? A. No.

Q. After the disclosure was made, were any changes made in the bookkeeping so as to reflect his interest?

A. No, there was no changes made, that I know of.

Q. Mr. Hammond, may I ask to what extent, if any, you are familiar with the bookkeeping or accounting methods? Do you know anything about that at all? A. Very little.

Q. Have you had any training in that at all?

A. None.

Q. Do you profess to understand anything about accounting methods?

A. I have difficulty reading a financial statement.

Q. Did you give any detailed instructions as to the manner in which the accounts were to be kept? A. None.

Q. Whom did you leave that to?

A. My office manager and my counsel, Mr. Jacob.

(Testimony of Ross B. Hammond.)

Q. And your bookkeeper? A. Yes.

Q. Could you state, generally, how contracting work is done? That is, state generally how you make bids on the contracts and [102] how they are operated?

A. Well, normally, we get a set of plans, figure the quantities and prices, put a price on the cost of doing business, doing the job, and bid on it and, if we are the successful bidder, we make a contract to complete the job on that basis, usually through an architect who represents the owner. Does that answer your question?

Q. That is all right as far as it goes, but I wanted to know: Is there more than one type of construction contract? Do you take them on a fixed amount or are there some that you take on a cost-plus basis?

A. There are many different types.

Q. Generally speaking, what types of contracts did you make during these years in question?

A. Well, we had some lump-sum contracts; we had some cost-plus percentage contracts, which is a percentage of the cost; we had some cost-plus-fixed-fee contracts, which is the cost of the operation plus a fixed amount of money which you are paid for doing it.

Q. Were those three——

A. I beg your pardon?

Q. Were those three methods the ones that were employed in the contracts that you took?

A. Normally, yes. We had one that was entirely different.

(Testimony of Ross B. Hammond.)

Q. What was this one you speak of that was entirely different? [103]

A. This was the Aluminum Company job at Troutdale.

Q. State what happened? First, let me ask you: Who was erecting the Aluminum Plant? For whom was it being done?

A. The Defense Plant Corporation, with the Aluminum Company of America as their agent.

Q. Is that a Federal agency?

A. The Defense Plant Corporation was a subsidiary of the Reconstruction Finance Corporation.

Q. It was, in effect, a Government operation?

A. Yes.

Q. State what happened in connection with that project from its inception?

Mr. Winter: Was the contract in writing?

Mr. Bischoff: No, it was not, at the beginning. I want the history of the transaction, leading up to the ultimate making of a contract.

Mr. Winter: We will object to that. The contract is the best evidence. The negotiations leading up to it would be incompetent, irrelevant and immaterial.

The Court: Go ahead.

A. Well, apparently they had no preconceived idea of what they were going to build at Troutdale, but they had to have some competitive bids.

Mr. Bischoff: When you say "they," whom are you referring to? [104]

A. The Defense Plant Corporation.

(Testimony of Ross B. Hammond.)

Q. And its representative?

A. Yes, the Aluminum Company of America. How many contractors they called I don't know, but they eventually called us to give them a price per cubic yard on concrete, including the excavating, the forms, the concrete, the steel, anchor bolts and engineering and overhead; and they couldn't tell us how much concrete was going to be used. They gave us a few prints, some prints, some buildings that were over at Vancouver, Washington, and some way down South, and in Mississippi. They were going to have some buildings like them. They wanted a price per cubic yard on the concrete to build them.

Q. This price-per-yard basis, was that to include all the steel and everything else?

A. Everything.

Q. That was the yardstick that was to be used for computing the compensation?

A. That is correct.

Q. Proceed from there.

A. Then we finally agreed on that price per yard. That is all we had, was a price per yard.

Q. At the time when you agreed as to the price per yard, did you have any information as to how much yardage you were going to have to do on the project?

A. We had a guess verbally by the man in charge of the project [105] for the Aluminum Company.

(Testimony of Ross B. Hammond.)

Q. Does the quantity of work that is to be done have a bearing upon the yardage price that is to be charged?

A. Very much. It takes the same amount of equipment, it takes the same amount of engineering, it takes the same amount of overhead to put 10,000 yards of concrete in or 50,000 yards. The only thing, it takes more quantity of material to put in 50,000 yards, and perhaps a little more time, but the same equipment that we had to buy to put the 10,000 yards would put in 50,000 or 60,000, so we were trying to find out—there wasn't any way of finding out definitely how much concrete that we were eventually going to put in.

Q. Was there any rough estimate made at that time as to what it might be?

A. Yes. The man in charge guessed that there might be 30,000 yards. We looked at it and we thought that there would be 15,000 yards, so we compromised and based our price in between. As a matter of fact, when we ended up there were 60,000 yards.

Q. How much? A. 60,000.

Q. 60,000 yards? A. Yes.

Q. How did that increase come about? What was the reason for that large increase?

A. They added more and additional buildings as they went along. [106] Sometimes the style and type were changed and, of course, the unit price per yard of concrete would not always apply, and we had to go on the assumption that we were going to be treated fairly and, on the statement of the man in charge, we kept pouring concrete, but we

(Testimony of Ross B. Hammond.)

didn't have any contract to pour the concrete.

Q. Did you have any writing at all when you started in to do that work?

A. When we started the first operation, I think we had a letter agreement of so much a yard for the concrete that we were going to put in, based on a few sketches of the job, the building that we were going to build but, before we got through, everything changed, and they put up a different type of building.

Q. But, ultimately, you did get a written contract covering that job?

Mr. Winter: He said he had a letter contract, whatever that is.

The Court: Did you have a contract?

A. Eventually, we had a purchase order.

Mr. Bischoff: Q. Before you had that purchase order, was there any way of knowing how much concrete you had to pour or how large a building you would ultimately have to construct?

A. No.

Q. Were you able at this point to estimate the profits you were going to make on that operation?
[107]

A. No, we couldn't find out how much we were going to get paid for it.

Q. In what year did this originate?

A. The Aluminum Plant?

Q. Yes.

A. Well, 1942, I believe, in the early part of 1942.

(Testimony of Ross B. Hammond.)

Q. Was it 1941?

A. Well, it could have been the latter part of 1941. It is quite a while ago.

Q. At any rate, did you get a written contract in the same year the work originated or did you get it during subsequent years?

A. I can't recall. We probably started out there before we had any thing written. It was speed, speed and more speed.

Q. Who urged you to get started without any contract?

A. The representative of the Aluminum Company.

Q. Did the war conditions have anything to do with your determination to go ahead without a contract?

A. Well, we were also patriotic besides being businessmen and we knew that eventually we were going to get paid. We had to win the war or it would not make any difference.

Q. Was that the only instance of that kind, in contract work that you did during the years from 1941 to 1944, that type of contract?

A. Never had a type like that before or since, in the thirty-seven years I have been in the business. [108]

Q. With respect to the three other types of contracts, one being a lump-sum contract in which you took all the chances——

A. Yes.

(Testimony of Ross B. Hammond.)

Q. —and another, the cost-plus contract where your profit was figured on a percentage of the cost—— A. Yes.

Q. —and the third was a lump-sum contract, regardless of the cost? A. Yes.

Q. That is, you were reimbursed your actual cost plus a fixed sum for your services?

A. That is right.

Q. Was the method of payment the same in all of those contracts, that is, the interim payments or payments during the course of the work?

A. No, they could not be.

Q. How frequently were you paid on these contracts, weekly or monthly? A. Monthly.

Q. How did you determine the amount for which you were to send bills each month?

A. On the normal type contracts?

Q. Yes.

A. Well, we would put in a bill to the architect who, in turn, checked the bill and issued a certificate to us, which we would [109] send to the owner and which the owner honored with payment. That was the normal procedure.

Q. How was the quantity or the amount for which you rendered bills arrived at? What are those called in contractor's words?

A. Monthly estimates.

Q. How were those monthly estimates arrived at which were included in each month's billing?

A. Our staff, one of them—Bill or Petersen or Mason or myself—would figure out how much we

(Testimony of Ross B. Hammond.)

had done on a certain job; take it up to the architect and go over it with him. If he agreed with us, that was it, and we put on a formal request which he approved and attached his certificate of payment, which we presented to the owners.

Q. Was that uniform practice?

A. That was normal practice.

Q. I would assume on each job the one who was superintending the work prepared those estimates?

A. Yes, if it was a large job,—if it was a job where we had somebody in charge of it that was big enough to do it.

Q. In other words, if Mr. Mason was in charge of the job, he kept the estimates and did those things you have described? A. Yes.

Q. If Bill was in charge, he did that?

A. Yes.

Q. So, he followed the normal way of doing it? [110]

A. That was the normal procedure.

Q. And that was the way it was followed out?

A. Yes, and then, of course, we checked the invoices which were at the office and not at the job.

Q. But in any event, before the invoices were submitted, the approval of the architect or engineer, or whoever was in charge for the owner, was obtained? A. That is right.

The Court: I think we had better break off now. You are getting into another subject.

Mr. Bischoff: Yes.

The Court: What time do you want to resume?

(Testimony of Ross B. Hammond.)

Mr. Bischoff: Two o'clock.

Mr. Winter: I would like to commence at one-thirty, if the Court please.

The Court: We are certain not to get through today.

Mr. Bischoff: I would prefer two o'clock, your Honor.

The Court: Two o'clock, then.

(Thereupon a recess was taken until 2:00 o'clock p. m.) [111]

Court reconvened at 2:00 o'clock p. m., Tuesday, January 13, 1948.

ROSS B. HAMMOND

plaintiff, having been previously duly sworn, resumed the stand and further testified as follows:

Direct Examination—(continued)

By Mr. Bischoff:

Q. Mr. Hammond, I was asking you about the method of making your monthly estimates to the owners at the end of each month, and you explained how that was done, in one instance.

With respect to the other three methods, that is, the fixed-amount contract where you take a contract for a lump sum and you take all the chances, and the contract, a cost-plus, percentage of the cost, and the third where you have the cost plus a fixed fee. How do you determine the monthly estimates in those three particulars?

A. Well, they are all determined approximately the same way, submitting the monthly estimate to

(Testimony of Ross B. Hammond.)

the architect who approves it and issues his certificate, which certificate we present to the owner for payment. They are all on practically the same basis.

Q. In the case of the Aluminum Plant job, did you submit any monthly estimates during the time you had no contract?

A. No, we couldn't. It was not recognized. We could not complete anything.

Q. In other words, you kept spending money for labor and [112] materials but you were in no position to bill them?

A. In the latter part of the job, yes.

Q. When you say "latter part", does that mean after you got your contract?

A. No. In the first part of the job, we would have the engineers on the job for the Aluminum Company with our engineers check the quantity of yardage which we had installed, which we had a unit price for, and that they would approve unofficially. Then we would make it out and send it through channels. It would go to the engineer who had already checked it, who would send it through to the main office; then, in turn, it went to the Aluminum Company, Pittsburgh office, then to the Defense Plant Corporation, Cleveland office, and it was finally sent back to some other office and eventually we got a check for it; but there was more of the job that we were pouring concrete on for which we had no prices established, so all we could do then was to keep pouring concrete but

(Testimony of Ross B. Hammond.)

we could not submit an estimate because there wasn't any order to check the estimate with.

Q. And, not being able to submit an estimate, you did not do any billing?

A. No. As a matter of fact, we did do some billing, and they sent it back to us saying we could not bill it.

Q. Do you remember when you concluded to dissolve the corporation and carry on your operations in your own name? You remember the occurrence? [113] A. Yes.

Q. Was the corporation dissolved at the end of 1937?

A. Approximately then, I remember.

Q. At that time, did you take up with your counsel and bookkeepers the matter of determining the method of accounting which you were to employ individually, after the dissolution of the corporation?

A. I think my bookkeeper took it up with me and said it was a very bad method to follow through, for several reasons. One was that I——

Q. The method that had been formerly used?

A. Yes.

Mr. Winter: We will object to what the bookkeeper told him as being heresay.

The Court: Go ahead.

A. Fortunately, I have to listen to my bookkeeper because I do not know much about bookkeeping.

(Testimony of Ross B. Hammond.)

Q. (Mr. Bischoff): As a result of her statement to you, did you take counsel and advice with respect to the method which should be employed?

A. Yes.

Q. Whom did you consult with?

A. I consulted with Mr. Jacob and my bookkeeper, who was very meticulous. While she wasn't a C.P.A., she was a very fine accountant. [114]

Q. You mean Mr. Jacob, who is counsel here in this case? A. That is right.

Q. Robert T. Jacob? A. That is correct.

Q. What was the name of the bookkeeper you had at that time?

A. Her name at that time was Edith Pack.

Q. Where is she now? A. New York City.

Q. When did she leave your employ?

A. I think it some time early in 1941.

Q. As a result of the consultations that you had as to the method of accounting that should be employed, did you come to some conclusion as to the method to be adopted?

A. Well, I was advised that the best method to use was the accrual method, and I hadn't any more idea of what that was than a rabbit, but I told them if that was the best method to use, let's get started.

There were some other things that entered into it, I remember, as I had been on a cash basis personally and I had accumulated a ranch, and I guess the ranch was a rather rough job on the accrual basis, and my bookkeeper attempted to check with

(Testimony of Ross B. Hammond.)

the Revenue Department to see if we couldn't keep that on the old basis and the construction business on the accrual basis, but they said "No," we would have to keep it all on one basis and, of course, the construction business being the larger, that [115] is what it was all kept under.

Q. Do you know why it is that the return, the tax return for the year 1938 was not made on the accrual basis?

A. Is that the last half of the Capitol Building?

Q. That is right.

A. Well, it was explained to me by my bookkeeper that in changing over—we had finished the contract, partially, on a basis—I think they call it a finished basis, but we were still—we still had some to complete when I did become an individual operator, and it was a confusing thing to know which to do.

I asked her, "Why don't you consult Jacob and possibly ask the Internal Revenue Department? It is something that has to be done," and, to the best of my memory, the information that she got was from the Internal Revenue Agent someplace that it should be carried on, that particular job, to make it consistent. That was her answer to me.

Q. The return, then, was made in the same manner as the corporation had reported earlier?

Mr. Winter: The return is the best evidence.

Q. (Mr. Bischoff): I am asking him.

A. To the best of my knowledge, yes.

(Testimony of Ross B. Hammond.)

Q. At any rate, an attempt was made to conform to it?

A. Yes, I presume so. I told her to do it.

Q. Mr. Hammond, what was your policy with respect to billing the owners for work? Was it the desire to get all the billing in [116] that you could?

A. Very much so.

Q. Why was that?

A. We needed the money. We billed as much as we could bill.

Q. You say "as much." You mean as much as you put into the contract?

A. All that we could bill legally, we would bill.

Q. Did that prevail all through the years?

A. All contracts.

Q. After Miss Pack left your employ, who became your bookkeeper?

A. She had had an assistant there who carried on for a short period; I think eight or nine months. But she was very definitely not going to stay because she was going to get married. We knew that. We wanted to find somebody that would be as permanent as possible, so—I don't remember her name even.

Q. You mean the assistant carried on for a while?

A. Carried on for a little while. I don't remember. It was not very long.

Q. After that, who became the permanent bookkeeper in you reestablishment?

A. Our present bookkeeper, Miss Novak.

(Testimony of Ross B. Hammond.)

Q. When did she start?

A. Some time early in 1942, the very early part of January or February.

Q. I call your attention to the fact that the contract, the [117] partnership agreement, was made February 3, 1942. Would that refresh your recollection as to when Miss Novak began?

A. She was there then. How long before that I don't know; it might have been a week; it might have been two weeks.

Q. At any rate, it was a very short period of time? A. It was a very short time.

Q. She has kept the books ever since?

A. That is correct.

Q. Did you inform her about the partnership agreement when you made it? A. No.

Q. At the end of the year 1942, or when it came time to make the income tax return for the year 1942, which would be along in the early part of 1943, did you inform Miss Novak, the bookkeeper, as to the partnership arrangement that had been made with your son? A. No.

Q. What, if anything, did you tell her to do with respect to your son's compensation?

A. Well, as I remember, I told her Bill was going to share in the profits after Petersen and Mason were taken care of in their agreements.

Q. Did you tell her to what extent he would share in the profits?

A. I told her it was about the same as Petersen's.

(Testimony of Ross B. Hammond.)

Q. Do you know whether she made entries accordingly?

A. I don't know. I never did see any entries.

Q. But you finally did tell Miss Novak about the partnership agreement?

A. I think Mr. Jacob called it to my attention in the first place that this return was not correctly made and, of course, then it was necessary to tell Miss Novak how it should be made and, in order to tell her that, I then told her about the partnership arrangement and, as I remember, I explained to her then why it had not been told to her previously and why it was essential that it be kept very confidential.

Q. Did you instruct her at that time to adjust the entries on the books to conform to the partnership relationship?

A. I told her to consult with Mr. Jacob and to be sure that the returns were properly taken care of, to correct the situation in whatever way it needed to be corrected.

Q. Mr. Hammond, in the opening statement of counsel for the defendant some mention was made about some figures with respect to the Troutdale Aluminum Plant. He pointed out that in the Troutdale Aluminum Plant contract, No. 208, that in 1941 the records show an accrual of income of \$59,775.31 and a profit of——

Mr. Winter: Mr. Bischoff, I have a typewritten copy that I might loan to the Court if the Court would like to follow it.

(Testimony of Ross B. Hammond.)

Mr. Bischoff: Yes, I would like the Court to follow it.

Mr. Winter: I think it is correct.

Mr. Bischoff: Your Honor will find about the center of the [119] page the title "Troutdale Aluminum Plant" and the figure "208" after it.

Q. He pointed out that, according to your books, you had an income of \$59,775.31 in 1941 from that job, and that your books showed a profit of \$23,544.42—Your Honor will find that at the end of that column.

Can you explain why so much credit was made in that year on that job? A. Yes.

Q. Will you, please?

A. When we went out there, just after we took over the contract, they changed the setup and there was a lot of clearing to be done, and we figured the price with all of the things that we thought might happen on that clearing, and it was going to be plenty tough.

Q. What clearing would have to be done? What was the nature of the terrain and what would have to be done as conditions existed at that time?

A. At that time it was pretty well soaked; it was low; it was just above the water line, and we figured putting in heavy equipment and so forth and clearing this was going to be a very costly thing, and they insisted—this was aside from any contract or any agreement that we had, an entirely new thing, and they wanted a lump-sum price on it.

Q. Let me interrupt a moment. Was this some-

(Testimony of Ross B. Hammond.)

thing different from [120] the construction of the buildings? A. Yes.

Q. Something independent?

A. Something that came up afterwards.

Q. Very well. Continue.

A. So we gave them a lump-sum price for that, which they insisted upon, and none of the things, of course, happened that we thought were going to happen, with the result that we did take over the job and made a tremendous amount of profit.

Q. The thing that you did not have to do was what? A. Clearing.

Q. Yes. Was there any filling done there by the Aluminum Plant?

A. The Aluminum Company decided to pump six feet of sand out of the river, which had never been contemplated at all before.

Q. Did they do that work?

A. They did the work themselves.

Q. What effect did that have upon the cost of operation to you?

A. Eliminated most of it.

Q. And resulted in a profitable operation?

A. A very profitable operation.

Q. It was pointed out also by Mr. Winter in that statement, with respect to the same job, in the year 1942, your books show that you received an income in the sum of \$1,036,623.16 and that your total costs during that year were \$1,057,459.83, with a loss in that year on that job of \$20,786.73.

Will you explain why, in that year, this operation showed a loss?

(Testimony of Ross B. Hammond.)

A. Most of it was because of our inability to bill most of the work.

Q. That was the job you have explained before where you did it without any contract?

A. That is right.

Q. In the following year you were able to bill for all the work?

A. Finally we got a purchase order for most of this work we had done in the latter half, at least, of the year before.

Q. And the ultimate profit was reflected in the following year, then?

A. That is correct.

Q. That is, it showed in 1943 an income of \$274,431.59, with a total cost of \$180,494.97, or a profit at the end of that year of \$93,986.62.

A. That is correct.

Mr. Bischoff: You may cross-examine.

Cross-Examination

By Mr. Winter:

Q. Just refer, Mr. Hammond, to Contract 207. You will notice the income per books is \$7,634.09 for 1943. A. 1943.

Q. \$7,634.09 for 1943. Do you notice that?

A. Yes. [122]

Q. With a total cost of only \$575.12, and you show a profit from these books of \$7,058.97.

Will you explain that distortion to the Court?

A. Yes.

Mr. Bischoff: Wait a minute. I object to the use of the term "distortion" as counsel's conclusion.

The Court: Well, I have been here a long time now and I have my own vocabulary.

(Testimony of Ross B. Hammond.)

Mr. Bischoff: You may answer, the Court said.

A. Yes. After we had completed, or thought we had completed, the Milwaukie Housing Project, the architect would not issue a certificate for all the money that was in our contract, which was a lump-sum contract, because he stated, or at least contended the owners stated, that we had not finished some work in the playground on which they held up some \$7,500 and which we could not bill because they would not give us a certificate, but later in the year we finally agreed with the architect and the Milwaukie Housing Board, I think it was, that if we did certain things to the playground that they would then issue a certificate for the full amount of the contract.

Q. (Mr. Winter): However, you content——

Mr. Bischoff: Let him finish.

Mr. Winter: I thought he had finished.

A. But the additional work we had to do to the playground was a very small amount of work, which is reflected in what it cost [123] us, so our cost was immaterial, but the money was the balance of the payment on the job which we could not bill because we could not get the architect's certificate.

Q. Therefore, the cost to earn the income of \$7,634.09 is necessarily reflected in either 1942 or 1944, isn't that true?

A. No, it is reflected in that last year.

Q. In 1944?

A. When we finally got the certificate. What year was that? 1943, wasn't it?

(Testimony of Ross B. Hammond.)

Q. You had expended the necessary costs to complete that job in 1942, hadn't you?

A. As far as we were concerned, yes.

Q. As far as you were concerned? A. Yes.

Q. You could not bill it until 1943?

A. That is right, because we could not bill it until we got the architect's certificate.

Q. In other words, you had expended all the material and labor in 1942 to complete the job and the job was completed except for getting a certificate and your ability to bill it?

A. So far as we thought.

Q. Did you at any time, in either of these contracts in 1941 or 1942 or 1943, ever take an inventory of the stock pile of materials on hand at the end of the year? A. No. [124]

Mr. Bischoff: Wait a minute. That is objected to, may it please the Court, on the ground that there is no requirement in the Internal Revenue Law requiring an inventory in a contracting operation when the taxpayer is on an accrual basis.

The Court: What is your position about that?

Mr. Winter: Our position, if the Court please, is that under the regulations consideration must be given to stock piles of material on hand or work in progress at the end of the year.

Q. What is your authority?

Mr. Winter: Well, the statute and regulations, if the Court please. Section 29 of the regulations says, if the Court please, that there shall be deducted from such gross income all expenditures

(Testimony of Ross B. Hammond.)

made during the tax year on account of the contract, account to be taken of the materials on hand and supplies on hand at the beginning and end of the taxable year for use in connection with the work under the contract and not yet so applied. In other words, the regulation——

The Court: What did you read from?

Mr. Winter: The regulation.

Mr. Bischoff: Let's have the regulation.

Mr. Winter: I haven't got a copy of the regulations here, if the Court please, but certainly I believe on cross-examination we should be able to go into the question of what was actually done with respect to these contracts.

The Court: I have not stopped the cross-examination. I just [125] wanted to know the number of the regulation.

Mr. Winter: Of course, this question is very broad and very comprehensive. I expect to prove it, if the Court please.

The Court: I want the regulation, if you have it. You just read something. Where did that come from?

Mr. Winter: Notes I made in connection with the preparation of this case, if the Court please. I did not bring the regulations.

The Court: Mr. Bischoff says there is no such regulation.

Mr. Winter: I think I have got it here someplace.

The Court: I was looking at your pleadings on another subject. I find an amended answer but I

(Testimony of Ross B. Hammond.)

have not found an amended complaint. Is there an amended complaint, Mr. Bischoff?

Mr. Bischoff: No, your Honor. The amended answer was not permitted, your Honor.

The Court: Oh, yes. I have got my parties twisted. I am straightened out now. We might as well settle now, if we can, the difference between you. Mr. Bischoff says there is no regulation applicable to contractors to require them to take an annual inventory as a matter of accounting for tax purposes.

Mr. Winter: If the Court please, we do not agree with counsel that the contracts were reported on a strict accrual basis. As a matter of fact, I want to call your Honor's attention to the return for 1938.

The Court: I would like to find out where you were reading [126] from. Do you know what he read from, Mr. Bischoff?

Mr. Bischoff: No, I don't, your Honor. There is one regulation that we know of that deals with inventories and that is Section 42-3 of Regulation 111, which was in effect for a period of time from the end of December 31, 1941, and that provides—If your Honor wishes me to read it.

The Court: No. You can state it better.

Mr. Bischoff: It is limited to a merchandising operation, like a grocery store or something of that order.

The Court: Go ahead with your cross-examination, Mr. Winter.

(Testimony of Ross B. Hammond.)

Q. (Mr. Winter): Have you answered my question? I wish you would re-answer it.

The Court: Before you go any further: I see the complaint is pretty sketchy. You have not worked up a pre-trial order in this case. I don't know whether you will be able to or not, from what the Clerk tells me.

Paragraph VI of the complaint says: "That said deficiency assessment and collection was illegal in that defendant refused to recognize the partnership entity of the Ross B. Hammond Company, and made arbitrary re-allocations of income."

Am I to understand that those things are not to be read together, that the defendant refused to recognize the partnership entity, for one thing, and made arbitrary re-allocations of income?

Mr. Bischoff: Is your Honor directing the inquiry to me?

The Court: That is your complaint I was reading from. [127]

Mr. Bischoff: There are two issues in the case, one the existence or non-existence of a partnership. That is a distinct issue which will affect the computation and——

The Court: You notice the allegation, that it is illegal in that defendant refused to recognize the partnership entity and made arbitrary reallocations of income. Does that latter clause "and made arbitrary reallocations of income" stand as an independent clause?

(Testimony of Ross B. Hammond.)

Mr. Bischoff: It is an independent clause, and that relates to the reallocation which was made of the income to different years, taking the income out of 1941 and putting it into 1942 and taking it out of 1943 and putting it into 1942.

The Court: Go ahead, Mr. Winter.

Mr. Bischoff: If I may add one further observation to clarify the issue: When your Honor sees these Revenue Agent's reports you will see that there is no issue of any kind tendered about the figures or the amount of income accrued. The sole question that is raised by his report, when your Honor reads it all through, will be whether we should have taken the whole of that accrual in each year or only a percentage of it. It involves a question of accounting methods. It also involves a legal interpretation of the term "clearly reflect the income."

Mr. Winter: Of course, it is the Government's position that the burden is on the plaintiff to show that he has overpaid this tax. They just cannot single out one thing and say that they [128] have done all that they have got to do, that they have taken the correct deduction and that they have overpaid their tax. The Court refused to allow us to file an amended answer so we could set that forth more in detail, but the burden is on the plaintiff to show that he has overpaid his income tax before he can recover in this action.

One of the defenses which we are setting up is that he took an unallowable deduction on his in-

(Testimony of Ross B. Hammond.)

dividual return by accruing the salary paid to Mason and Petersen which had not, in fact, accrued on his accrual basis of accounting.

Mr. Bischoff: There is no obligation on our part to put in any evidence concerning facts which are conceded by the Commissioner. The official Revenue Agent's report, which is the basis of this assessment, is in evidence, and it discloses the adoption of certain facts about which there is no dispute, and we did not have to put in evidence concerning the adoption of our figures, and the extent to which they were used.

The Court: Does the report criticize the fact that inventories were not taken?

Mr. Bischoff: Yes. I do not think he uses the term "inventory." If I recall correctly, I think he uses the term "work in progress," which is, in a sense, the same as inventory. I would not want to say with absolute certainty that he does not use the word, but I do not have any recollection of him using the word "inventory," but he criticizes the failure to [129] have an account which shows the work in process, and our position is that neither inventory or work in progress is essential to an accrual method for a contractor, because it does not reflect anything which we could show in the income tax return.

The law says that we can only take as income whatever moneys we have a right to receive. That is the limit of what we can do. We may have spent a great deal more, but if that is all we can do, that is all we can set up.

(Testimony of Ross B. Hammond.)

Just as Mr. Hammond pointed out with respect to this last item. He thought he was entitled to that \$7,500 but they would not pay it. They refused to certify it, so he could not bill for it, and it could not be accrued. The next year, he spent \$500 to do something and then they agreed to pay it, so he accrued it in that year, and that is what the law requires. We are bound to accrue everything for which we incurred liability. If we do not do it in that particular year, we cannot do it in a subsequent year, even though we pay it in the next year. It is not a matter of our choice. That is what the law tells us to do.

The Court: All right. Proceed.

Q. (Mr. Winter): Mr. Hammond, will you refer to Job 213, appearing on page 19 of the report?

A. What number?

Q. Contract 213, the Columbia Steel Casting Plant. A. Yes. [130]

Q. I notice that you report on your return income received from that job for the year 1943 of \$375,430.50. A. Yes.

Q. But a profit of only \$10,159.76. Was there a good deal of work in progress or material on hand at the end of that year?

Mr. Bischoff: That is objected to on the same ground, your Honor, involving——

Q. (Mr. Winter): That you could not bill for?

Mr. Bischoff: Just a minute until I get through, please.

The Court: Admitted, subject to the objection.

(Testimony of Ross B. Hammond.)

A. I am not familiar with the details of that job, but I would presume that it was in the same category, because the accounting was done on the same basis. I never attempted to go into the books.

Q. (Mr. Winter): You never attempted to estimate any work in progress for which you could not bill at the end of the year?

A. The only way I could answer that is that we attempted to bill everything that we had authorization from the architect to bill to the owner. All of our authorization came through the architect or engineer. That was another Defense Plant Corporation operation.

Q. In any construction project there is a considerable amount of work at the end of the year for which you cannot bill?

A. Normally, yes.

Q. In these large contracts you have to maintain a substantial [131] stock pile of materials, so that your work won't be stopped, is that right?

Mr. Bischoff: I wish to make an objection at this time. I will ask the Court that our objection may be deemed to go to any other questions that may be asked along the line of the question of work in progress or the question of an inventory.

The Court: Yes.

(Question read.)

A. No, that is not necessarily the fact. Some of them have a stock pile; some of them have not. It depends on the particular job. On some jobs we have practically nothing that is not in the work. On some jobs we may happen to get a couple of carloads

(Testimony of Ross B. Hammond.)

of cement or a couple of carloads of steel that we may not be able to bill, but it is charged to the job, as a rule.

Q. (Mr. Winter): In some contracts, of course, they only permit you to bill 75 or 80 per cent of work completed, the amount of work completed, is that right?

A. That is mostly true in a lump-sum contract.

Q. Then, the 20 per cent would, therefore, be postponed for billing until the next year?

A. I presume so. I don't know.

Q. In other words, would you say that was the reason why you show an income of \$375,430.50 and only a profit of \$10,159.76 in that year, whereas you only have income received of \$35,139.81 in 1944 and you show a profit of \$27,610.51, is that right? [132]

A. I can't answer that question. I don't know enough about the facts of that particular job to answer your question intelligently.

Q. You don't know what was accrued or what was not accrued?

A. No, I never had anything to do with the books.

Q. So far as you know, did anyone under your supervision, in your jurisdiction, take an inventory of stock-piled materials or work in progress for which you could not bill at the end of the year?

A. As far as I know, we never used what you apparently term an inventory. However, the material that is bought and sent to a job, and for which we have received a bill and for which we are liable, is charged to the job.

(Testimony of Ross B. Hammond.)

Q. Even if that material was to be used in a subsequent year, it would still be charged?

A. It would still be charged to the job when it was billed, to the best of my knowledge.

Q. Job 213 shows that you had over \$400,000 income. No. That job was completed in 1944, I presume.

Mr. Bischoff: What job are you talking about?

A. Apparently.

Mr. Winter: Contract No. 213 is the one we are talking about.

A. Apparently; it says 1944.

Q. Contract 215, Northwestern Ice Company: You have an income received of \$51,583.98 and you show no net profit reported. [133]

A. If I remember that job correctly, that was another one of these Defense Plant Corporation jobs. That was a Defense Plant Corporation job, the same as the Columbia Steel Casting Company and the Aluminum Company.

Q. Do you consider you did not have any income in 1943 from Contract No. 215?

A. In earnings from work?

Q. Or material?

A. According to our books.

Q. You did not have any?

A. Apparently not, not from this.

Q. But you operated at a profit on substantially all of your contracts?

A. We hoped to, but there was quite a few that we never knew whether we were going to until we got them finished and a chance to bill them.

(Testimony of Ross B. Hammond.)

Q. Contract No. 217, on page 20.

A. Kaiser Reserve Warehouse.

Q. You have an income in 1943 of \$87,300.25 and costs of \$83,885.39, showing a profit of \$3,414.86. Is that right? A. Yes.

Q. And in 1944 your income from that job was \$110,397.75 and your costs, \$94,619.81. In other words, the costs are substantially the same as in 1943, but you have five times the profit in that year? [134]

A. Mr. Winter, that might happen on every job or any other job. It is a question of how you can bill it and what you have to charge against it. Sometimes these jobs show a much larger profit and sometimes they show a smaller profit. Some of these—As I remember, the Kaiser Reserve Warehouse was a lump-sum job.

Mr. Bischoff: You mean a lump-sum fee?

A. Guaranteed contract, yes.

Mr. Bischoff: Cost-plus-fixed fee, is that it?

A. No, a bid job in which we were low bidder, and we were going to do that much job for that much money. I am not sure of that.

Mr. Winter: I wonder if I might examine the witness without interruption?

Mr. Bischoff: I beg your pardon.

Q. (Mr. Winter): This Aluminum Company of America job, when did you secure that contract?

A. Some time in the latter part of 1941, as I remember it.

(Testimony of Ross B. Hammond.)

Q. I show you what has been marked and introduced in evidence, I take it—I show you Contract No. 208.

Mr. Bischoff: Marked for identification. It is a part of one exhibit.

Q. (Mr. Winter): That is the first contract you had with the Aluminum Company of America, that Contract 208, is that right?

A. I believe that is correct.

Q. What does that contract cover? First, when is the contract [135] dated?

A. November 15, 1941.

Q. Was that the time you entered into a contract with them?

A. That is right. It must be the time. That is when it is dated. We might have done a lot of things before that is actually dated.

Q. And that was a contract for what? What work?

A. This is the first part of the Troutdale Aluminum Plant for the Aluminum Company.

Q. Then you had two subsequent contracts with the Aluminum Company of America, did you not?

A. We had several. Whether there were two or more I don't know.

Q. One covering labor and materials and brick work?

A. Yes. This was different. This covers the concrete work that I explained before. The brick work was an additional contract.

Q. Did you have two contracts that you were working on out there in connection with the Trout-

(Testimony of Ross B. Hammond.)

dale Aluminum Plant? I mean two different jobs that you were working on at the same time, I mean in the same area?

A. Yes, it was all in the same area, in the area that was covered by the Defense Plant Corporation, the Aluminum Plant.

Q. I know, but in your records you more or less had Contract 208 and Contract 208-A that were started as one, is that right—considered as one for billing purposes?

A. What is 208-A? [136]

Q. Both are Troutdale Aluminum Plant contracts.

A. Yes. This is Amendatory Agreement No. 4, and it is apparently amendatory of that one because—Let me look at it a minute. This is something that had not been covered at all. It was brick paving and it could be that there was some brick walls in a building. I am not sure. Apparently not. This is apparently the only brick paving.

Q. In your income tax return for 1942, Plaintiff's Exhibit No. 6, the costs for 208 and 208-A were consolidated.

A. I guess I don't understand that question.

Q. In other words, you consolidated the costs and income from those two contracts, 208 and 208-A?

A. That could be. I don't know.

Q. In other words, all the material was out there, and no inventory was taken of that and still the costs are consolidated?

(Testimony of Ross B. Hammond.)

A. We didn't take any inventory; if they were delivered on the job, they were used on the job and presumably shown in the books.

Q. On a contract for a construction job, what is the practice about having material on hand?

A. This particular job, we hauled it from the Columbia Brick Works in a truck. We never had any particular material on hand that I know of, except for a day or two.

Q. Wouldn't you have to have steel on hand?

A. For brick work; we don't erect the steel.

Q. What? [137]

A. We don't erect the steel for a building. I think the one you are talking about was a paving contract.

Q. A paving contract?

A. Yes, 208-A, according to this.

Q. What is 208? What does that cover?

A. This is for the brick work on four or five different buildings, but the steel frame was erected by someone else. All we had, or all we did was to put up the bricks.

Q. All you had was the contract for the brick?

A. For the brick, yes.

Q. What is your explanation for the difference where you have \$1,036,623.10 of income and you have a loss of \$20,786.73?

A. I just explained that. We couldn't bill it because we had nothing to bill it on.

Q. What does that cost consist of, materials on hand and work partially completed?

A. Perhaps consisted of materials or work partially completed.

(Testimony of Ross B. Hammond.)

Q. What was your total profit on those two contracts? A. On what, 208 and 208-A?

Q. Yes.

Mr. Bischoff: You mean the total cost?

Mr. Winter: The total profit on those two contracts.

A. I think I will have to have some help. The profit from the books, \$96,694.31. That is on 208. The other one, 208-A, \$57,789.20. [137]

Q. When was that contract completed, Troutdale 208?

A. To the best of my knowledge, in 1944. I would have to get more information to be specific.

Q. It was in 1943, wasn't it, Mr. Hammond?

A. It could be.

Q. Most of the work in construction was done in 1942, when you expended \$1,057,409.83, isn't that right?

A. Well, according to this. If this is our return, we spent \$1,057,409.83 in 1942, plus \$200,000, more than \$200,000, roughly——

Mr. Bischoff: You are reading the wrong one.

Q. (Mr. Winter): You are reading the wrong one. Your total cost in 1941 was only \$36,230.89.

Mr. Bischoff: Go down further to "Total Costs" and read across.

A. \$36,230.89, \$1,057,409.83 and \$180,494.97, which shows the majority of it was done in 1942.

Q. (Mr. Winter): As a matter of fact, while it was approximately \$213,000 in 1941 and 1943, the total costs were nearly \$1,057,000 in 1943—1942, I should say.

(Testimony of Ross B. Hammond.)

A. 1941 and 1943 it shows about \$216,000 and in 1942, \$1,057,409.83.

Q. You paid all your employees salaries?

A. Yes.

Q. You were accruing all the billings for all material that was ordered during that year, whether it was included in the inventory or not? [139]

A. I don't quite understand.

Q. All your men were paid weekly, I think you explained? A. That is correct.

Q. All your other costs were accrued at the end of the year, regardless of whether or not you were able to bill for the material on a job or not?

A. If we had ordered the material, we charged it to the job, on our books.

Q. Regardless of whether you were permitted to accrue any billings for work to be done in the next year?

A. Well, according to our method, as far as I knew it, when we ordered it, it was a cost on the job; when we collected, it was an entirely different item.

Q. Mr. Hammond, let's go back to the partnership matter. You say prior to 1938 you operated as a corporation, is that right?

A. Pardon me?

Q. You operated your business as a corporation?

A. Yes, up to, I think——

Q. ——December 31, 1937?

A. I think that is correct.

Q. You were the sole stockholder of that corporation, were you? A. No.

(Testimony of Ross B. Hammond.)

Q. Except for qualifying shares?

A. Yes, except for qualifying shares.

Q. Your son was not a stockholder? [140]

A. No.

Q. He was in school in 1938? A. In 1938?

Q. Yes.

A. Yes, I believe he was at Stanford.

Q. I think you said he finished in——

A. ——'40, I believe, '40 or '39. I would have to check with him on that.

Q. Well, you had formed your corporation and at the time you dissolved the corporation you had the State Capitol contract?

A. Yes, it was in the process of erection.

Q. I think it was stated that you began in 1936 and you finished in 1939, is that right?

A. No, I think it was started either in the latter part of 1936 or early 1937 and we finished in 1938.

Q. Will you refer to your income tax return? Maybe I can save a little time here. Your 1938 return shows that it was 98-3/10ths complete in December 31, 1938?

A. Yes, I presume so.

Q. 1938 was the first year you operated individually? A. That is correct.

Q. Then, in 1939, you reported the balance of the profit not previously reported?

A. I haven't those figures here.

Q. Will you refer to the return? [141]

A. I presume if that is on the return, that is correct.

(Testimony of Ross B. Hammond.)

Q. You also report a portion of the contract completed with respect to Contract 196, with respect to the 1285 Barracks Building?

A. That could be, if it is on the report.

Q. When did you complete the 1285 Main Barracks Building, do you remember that? Look at your 1940 return.

A. No, unless you tell me when it was.

Q. Portion of contract completed in 1940, \$17,947.58, and you reported a profit of \$262.53?

A. If that is the United States Certificate, that is authentic.

Q. You were, in 1938, 1939 and 1940 reporting the portion of the building, the contract, that was completed?

A. Certainly, that is when we had certificates to show that it was that much completed. That certificate came from either the architect or the United States Engineer.

The Court: Take a short recess.

(Recess.)

Mr. Winter: Your Honor inquired about the status and regulations which the Government relies on. We rely on Section 41 of the Internal Revenue Code which provides: "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of [142] accounting has been so employed, or if the method

(Testimony of Ross B. Hammond.)

employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

There are two methods of keeping books, the accrual method and the cash method. The taxpayer requested on his own personal return that he be allowed to follow the same method as used by the Corporation in keeping books upon an accrual method.

With respect to long-term contracts, the statute authorized two methods, one, the percentage-of-completion method and, the second, the finally-completed-and-accepted method. The statute provides "Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

"(a) Gross income derived from such contracts may be reported on the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied."

(Testimony of Ross B. Hammond.)

In other words, if there was work in progress for which [143] they could not make a billing, in reporting a long-term contract, they can only accrue the percentage or amount which they have actually expended work upon and that they can bill for. Otherwise, the income is distorted.

With respect to the completed contract basis, the regulation also says "Taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion."

The request of the plaintiff for permission to report is contained in Exhibit 28. Mr. Hammond requested, in accordance with Section 29.42-4, permission to change his method of accounting. That section provides: "A taxpayer may change his method of accounting to accord with Paragraph (a) or (b) of this section only after permission is secured from the Commissioner, as provided in 29.41-2."

In other words, he asks for permission to come under this section of the statute and says,—

"In accordance with the requirements of Article 42-4, Regulation 94, application is hereby made—"

Mr. Bischoff: What are you reading from?

Mr. Winter: I am reading from a letter of Mr. Hammond to the Commissioner. [144]

"—In accordance with requirements of Article 42-4, Regulations 94, application is hereby made for permission to account for profits upon contracts performed by this company, upon the basis of a percentage of contracts completed within each calendar year.

(Testimony of Ross B. Hammond.)

“Doubtless this request is not necessary as no change is being made in the accounting methods heretofore employed, but on December 21st, 1937, the corporation, Ross B. Hammond, Inc., was dissolved and the business transferred to Ross B. Hammond, the sole stockholder of the corporation. The first return, of course, covering the operation of the business as a sole proprietorship, will be for the year 1938, and, as we understand the regulations, the method used upon the first return is optional with the taxpayer. However, since there has been a change in the form of organization, it is desired to take every precaution possible to see that the method heretofore employed by the corporation is perpetuated and that the new ownership is permitted to file upon the same basis as that used by the corporation.

“In view of the fact that the corporation’s books had been kept on the accrual basis, the individual books would be kept on a similar basis and the returns made accordingly on the accrual basis.”

We are not talking about reporting for long-term contracts; we are talking here about keeping of the books.

The Commissioner came back and advised Mr. Hammond under [145] date of March 29, 1938, as follows:

“Reference is made to your letter dated March 3, 1938, in which you request permission to report your gross income for the calendar year 1938 from contracts upon the basis of a percentage of com-

(Testimony of Ross B. Hammond.)

pletion of such contracts in accordance with the provisions of Article 42-4, Regulations 94, which is the same method used by Ross B. Hammond, Inc., the assets and business of which were transferred to you as sole stockholder on December 31, 1937, and now being operated as a sole proprietorship. It is assumed that no income was received by you as an individual from long-term contracts prior to January 1, 1938.

“You are advised that to the extent that your income is derived from long-term contracts as defined in Article 42-4 of Regulations 94, you may report your gross income from such contracts upon either of the two bases set forth in that article of the regulations. Whichever method is adopted by you in your first return must be followed for subsequent years, unless permission to change such methods of accounting is obtained from the Commissioner as provided in Article 41-2 of Regulations 94.”

Mr. Hammond comes back as follows in his letter of April 5, 1938:

“On March 3rd, 1938, the writer addressed a letter to the Commissioner of Internal Revenue stating that Ross B. Hammond, Inc., a corporation, had been dissolved, and the business transferred to me, the sole stockholder. I requested permission to report income from contracts, as an individual, on a percentage of completion basis, as the corporation had previously been doing, and to keep all accounts and make all returns on an accrual basis. Your

(Testimony of Ross B. Hammond.)

reply of March 29th grants permission to me to report income from contracts as the corporation had been doing, but makes no statement [146] regarding keeping all accounts on an accrual basis.

“Up to the year 1938, Ross B. Hammond, Inc., a corporation, made all of their returns on an accrual basis, and Ross B. Hammond, as an individual, who kept no books, made all of his returns on a cash basis.

“The corporation has been dissolved, and all future returns will be made as an individual, and, since the main income of Ross B. Hammond is from the construction business which has been kept on an accrual basis, we, therefore, request definite permission to make all future returns of Ross B. Hammond as an individual on the same basis as the corporation had previously made returns, which is the accrual basis.”

In other words, prior to that time he had been keeping his accounts on a cash basis, and he wanted to come on the accrual basis, as the corporation had been, but still report, of course, long-term contracts on a percentage of completion basis.

It is our contention that he did not follow the regulations and it was necessary for the Commissioner to re-audit them and reallocate the income in accordance with the best method we have been able to devise. I think it is clearly evident the income is grossly distorted—no inventory, no work partially completed. This is the only method which could possibly be used, without that other information.

(Testimony of Ross B. Hammond.)

Mr. Hammond, under date of May 9, 1938, wrote the Commissioner:

“Replying to your letter dated April 25, 1938, regarding permission to change my method of reporting income from cash to the accrual basis, beginning with the taxable year 1938, please be advised that all items on my personal return for 1937 were reported upon the cash basis, hence:

“(a) There was no accrual of income not received;

“(b) No income received in advance of when earned;

“(c) No expenses accrued but not paid; and

“(d) No expenses prepaid.” [147]

Mr. Hammond then wrote and said there was no accrual of income not received and, in response, then, the Commissioner of course sent him a letter saying that he could report—he could keep his books on an accrual basis the same as the Corporation had been keeping them, but the returns indicate that they have not taken into account the things that are necessary.

The Court: Did you find the regulation you read from earlier in the afternoon?

Mr. Winter: I beg your pardon?

The Court: You read earlier from a regulation. Did you find what that was?

Mr. Winter: That is this regulation that I was talking about, your Honor.

The Court: A couple of hours ago you read from a piece of paper. Are you able to give us now the regulation that that was quoted from?

(Testimony of Ross B. Hammond.)

Mr. Winter: I am producing the regulation which I quoted from, yes, your Honor.

The Court: Are we talking about the same thing? A couple of hours ago you read from a piece of paper and you did not have the number of the regulation. What is the number of it?

Mr. Winter: The number of the regulation is Section 29.42-4, in Regulation 111.

The Court: Re-read now what you read then.

Mr. Winter: You mean from the piece of paper? [148]

The Court: I am not suggesting you misquoted it but I would like to have it re-read now in the light of what you have been saying. If it is not handy, that is all right. Do you want to add anything further, Mr. Bischoff?

Mr. Bischoff: Yes, your Honor. I want to clarify some things.

The Court: I will hear you now. Don't bother about that, Mr. Winter. It is not important.

Mr. Bischoff: May it please the Court, all the law governing the method of accounting that is imposed upon a taxpayer is included in Sections 41 to 48.

The Court: Before you go further, he has found the paper now, apparently.

Mr. Winter: "There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning of the taxable period for use in con-

(Testimony of Ross B. Hammond.)

nection with the work under the contract but not yet so supplied.”

The Court: That is from the regulation?

Mr. Winter: That is from Section 29.42-4, Regulation 111. Similar provisions have been in Regulation 94, Regulation 103 and prior regulations.

Mr. Bischoff: Your Honor will recall that provision that he read from the piece of paper, and he now directs attention to the regulation providing for the method of accounting when a [149] taxpayer is on an accrual basis. We are concerned here now with that.

Mr. Winter: I said he kept his accounts on an accrual basis.

Mr. Bischoff: Now, are you through now? If you want to say anything, say it because I want to get through myself.

We claim we are on an accrual basis. They challenge our assertion that we are on that basis or have a right to be on that basis, and he said that there was a regulation which compels us to keep certain definite accounts in order to demonstrate that we are on an accrual basis. That is the statement he made to your Honor. Then he started to read from the piece of paper which he said applied to an accrual basis. I will presently demonstrate to your Honor that that is not the law at all and it does not apply to an accrual basis.

Section 41 to 48 of the Internal Revenue Code comprise all the laws, the Act of Congress which prescribes and imposes on taxpayers duties with respect to methods of accounting.

(Testimony of Ross B. Hammond.)

They first give the taxpayer the option to adopt any method that he pleases, providing that it clearly reflects the income. That is Section 41 and is the section read to your Honor in the beginning. Then, the Commissioner, pursuant to authority of law, adopts regulations to supplement the provisions of the statute and, among other things, he adopts a regulation which provides for permissible methods of accounting. The [150] statute itself authorizes, in express language, cash or accrual. The Commissioner devises an additional two methods which are optional, not compulsory, and he lays down in the regulation what is needed when you exercise an option to adopt one of these optional methods.

He first deals in the regulation with the method of accounting. This is found in Regulation 29.41-3 which deals with methods of accounting, and that is the label of the section, "Methods of Accounting." That section says: "It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required to make a return on his true income. He must, therefore, maintain such accounting records as will enable him to do so."

Under the first subdivision of that paragraph it says: "In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, inventories of the merchan-

(Testimony of Ross B. Hammond.)

dis on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year."

Obviously, this does not apply to a contractor who does not engage in buying and selling merchandise. The Commissioner recognizes in the ordinary mercantile operation that a [151] certain definite procedure is desirable and necessary and will be conducive to the production of a return that will reflect the income.

But, then, he goes on in the succeeding section and deals with the subject matter of long-term contracts, which is the thing we are concerned with here, and he says: "Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section, the term 'long-term contracts' means building, installation or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases," and then he sets forth under (a) and (b) two bases, one the percentage-of-completion and, the other, the completed-contract basis.

The regulation which he just told your Honor supports his contention that inventories and work-

(Testimony of Ross B. Hammond.)

in-progress accounts are essential to an accrual method is the statute or regulation that he read, and which applies solely to the adoption of a percentage-of-completion method. If we had done that in connection with our contracting business, we would have had to maintain our records as this regulation requires. That is what he [152] read to your Honor. This is one of the permissive methods in long-term contracts:

“Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificate of architects or engineering showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract not yet so applied.”

That is the requirement where we have elected to adopt the percentage-of-completion method. It was applicable to us in 1938 and in connection with the return in 1939 when we finished the State Capitol, but when we have elected the accrual method there is nothing in this regulation which imposes that kind of an accounting method, and the regulation that he read does not support that contention, nor support the idea that the Commis-

(Testimony of Ross B. Hammond.)

sioner—the very fact that the Commissioner saw fit to adopt a regulation of his own dealing with two specific types of taxpayers and providing specifically how they shall report, if they elect a certain method, carries with it the legal implication that as to all others this does not apply.

Then there is this second fact which I called to your [153] Honor's attention in opening, in this other regulation which he read and which I just concluded reading. It stops at the point where I have just stopped. In the prior regulations, added to this was the provision which authorized the Commissioner, at the end of the completion of a contract, after one, or two or three years, when you can ascertain the actual profit—the taxpayer could do it himself or the Commissioner could compel a recomputation of the whole operation in accordance with the profit which was determined upon completion; if the return did not clearly reflect the income for any year or years, the Commissioner might permit or require an amended return. In other words, it authorizes them to revise the whole thing and ignore the prior return and revise it, but that was eliminated. However, it is no longer permissible now, under any regulation, and, so, I say to your Honor that Mr. Winter has not demonstrated here that there is in existence any Act of Congress or any regulation promulgated by the Commissioner which imposes upon a contractor-taxpayer who adopts the accrual method to carry an account of inventory and to carry a work-in-progress account.

(Testimony of Ross B. Hammond.)

He is permitted and required to keep his accounts and report upon the basis which the law recognizes as applicable to that method, namely, accruing money that he is entitled to receive, and accruing liabilities that he has incurred in the year in which the accrual takes place. That is the situation we have here. [154]

Counsel read at length and rather hurriedly—I don't know whether your Honor could follow the import of the letters that he read, the letters that preceded the consent that was given to change the method of accounting. However, your Honor can read them for yourself and see what they contain, that series of letters which he read.

There was, apparently, a good deal of misunderstanding between the Commissioner and the taxpayer as to what the situation was, and that resulted in an exchange of these several letters. Your Honor will see, as soon as you read them, that the misunderstanding was clarified and that the Commissioner issued a letter of July 7, 1938, which reads:

“Reference is made to your letter dated May 9, 1938, submitting additional information in connection with your request for permission to change your method of reporting income from the cash to the accrual basis, beginning with the taxable year ending December 31, 1938.

“It is stated that at December 31, 1937, you had no accrual of income not received, no income received in advance of when earned, no expenses accrued but not paid, no expenses prepaid.

(Testimony of Ross B. Hammond.)

“It appears from the information submitted that there will be no duplicated or omitted items of income or deduction.

“Predicated on the foregoing, permission is hereby granted you to change your method of reporting income from the [155] cash to the accrual basis, beginning with the taxable year ending December 31, 1938.”

That was his final conclusion after the misunderstandings were clarified by the exchange of correspondence, the misunderstanding arising from this situation. The letter of Mr. Hammond's, when your Honor reads it, you will see, was written by a layman, not an attorney versed in income tax law or from a legal standpoint.

It called attention to the fact that the Corporation had started this State Capitol job and that the Corporation was being dissolved; that they had reported on a percentage basis for the Corporation and they wanted to report the balance of the operation in the year of completion on the same basis but, since Mr. Hammond was on the cash basis individually and they contemplated going on the accrual basis thereafter, they wanted permission to do that except for the year 1938.

That is all that correspondence does, when you take these letters all together. You will see, when your Honor reads all the correspondence, that the Commissioner's office did not quite understand the situation; it had not been made very clear in the first letter, and they exchanged two or three letters,

(Testimony of Ross B. Hammond.)

and it finally was clarified and it resulted in this permission being granted. That is all in the world that we have.

But, over and beyond that, assuming that they had never gotten any permission to report on the accrual basis, it has now [156] been definitely adjudicated by a decision that where a taxpayer has consistently reported on a given basis year in and year out for several years and the returns have been audited and have not been challenged, that will be deemed the equivalent of permission to use that basis of accounting, that method of accounting. In that connection, I call your Honor's attention to the case of *Fowler v. Commissioner of Internal Revenue*, 138 F. (2) 774, where the Court said:

“The requirement that a taxpayer, after electing to use a method of accounting in income tax, must follow such method in returns for subsequent years, unless permission is granted by the Commissioner to change to another method, may be satisfied by Commissioner's acceptance of returns which give notice to him that the method originally adopted has been changed, and the situation then stands as though Commissioner had given express permission to allow change in method of accounting.”

That is the situation here, regardless of all the quibbling there may be with respect to formal consent and the misunderstanding they had in their early correspondence. If we had nothing of that here, the Court would be bound, if it followed this decision, to say that this taxpayer, mistakenly or

(Testimony of Ross B. Hammond.)

otherwise, assumed he had a right to report on the accrual basis since 1939. He did so during 1939, 1940, 1941 and 1942. In all the years except one the Revenue Agent never challenged the right to proceed on an accrual basis, and, therefore, the Commissioner will be deemed to have consented.

Mr. Winter: Is it your contention that you had a different basis for 1938 than you had for 1942?

Mr. Bischoff: Our contention is that, beginning January, 1939, we were on the accrual basis; that we had a right to be on that basis; that we had permission to be on that basis; that we kept our accounts on that basis; made our returns on that basis.

Mr. Winter: What basis do you contend you were on for 1938?

Mr. Bischoff: I don't know. It doesn't make any difference what it was. Those years are not involved. We are concerned only with the years in controversy here.

The Court: Proceed, Gentlemen.

Q. (Mr. Winter): Mr. Hammond, I think you said you are not a bookkeeper and you have had very little experience in bookkeeping; that you are a contractor? A. That is correct.

Q. Are you familiar with income tax regulations? A. I probably never saw one.

Q. I show you what has been marked for identification as Pre-Trial Exhibit No. 28. Did you write that letter or did someone else write it for you?

(Testimony of Ross B. Hammond.)

A. Very probably it was dictated by my attorney.

Q. You mean Mr. Bob Jacob, counsel here? [158]

A. Mr. Bob Jacob, yes.

Q. The billings which have been marked for identification as Pre-Trial Exhibit No. 21, those are billings which were made by the contractor to the owner, your billings to the owner, is that right?

(Question read.)

Q. Is that right?

A. I presume so. They were billed on our letterhead.

Q. When you made the billings were the billings made on the percentage of the building which was completed as of the time of the billing?

A. Not necessarily. They were made on the authorized amounts that the architect or engineer permitted us to bill.

Q. In other words, on engineer's estimates as to the percentage of completion at the time of billing?

A. On estimates by the architect or engineer as to the amount of money we were entitled to.

Q. It was based on the percentage of the work?

A. That I couldn't say.

Q. It was based on the percentage of the money and materials you had expended in the contract, is that right?

Mr. Bischoff: The question is, in effect, calling for a conclusion.

Mr. Winter: This is cross-examination.

Mr. Bischoff: That does not authorize the witness to testify [159] about legal matters. There is a

(Testimony of Ross B. Hammond.)

question of interpretation as to what is meant by "percentage of completion." The Revenue Agent in his report makes quite an issue of that as to the percentage of the completion of the structure as a whole and percentage of completion of the component parts, and he says in his report the engineers only determined the percentage of completion of the component parts but did not determine the percentage of completion of the whole building, so there is a legal question as to what is meant by that term. The question as asked calls for a legal conclusion.

The Court: I think I know what a contractor can get. He can get whatever the engineer or architect allows him. They have some very funny ideas sometimes. All I can say is that I am not confused and I think I know what you gentlemen are disputing about now. Go ahead and ask your question again, Mr. Winter.

Q. (Mr. Winter): Mr. Hammond, is it not a fact that the billings were based upon the amount of work which had been completed and approved by the engineer as of that date?

A. Billings were made on the amount of money that was approved by the engineer as of that date.

Q. They were also based on the amount of work or the amount of labor and materials that went into the building?

A. Not necessarily. It was based on what the engineer thought it was worth.

Q. You mean on the part that was completed?

(Testimony of Ross B. Hammond.)

A. If I can, I will explain it a little bit. He starts in with the excavating and he takes each item and, as he goes through, he decides that we have got that much done. Whether we like it or whether we don't like it, that is what he says. When he gets through, he adds them all up and says, "You can have that much money."

Q. On some of the contracts you were only entitled to 80 per cent of the amount which you would estimate?

A. The contracts vary. When he gets through, then they automatically take off 5 per cent, 10 per cent or 15, which they hold back as assurance that you don't break a leg.

Q. The billings which were accrued on your books were for the total amount, without that percentage off?

A. When they get the bill, the percentage is off.

Q. Let's come to the partnership matter. Your boy, you say, was in college up until 1940?

A. Approximately, yes.

Q. Did he work for you during 1940?

A. I believe he did.

Q. How about 1941? A. Yes.

Q. Did he work the whole year of 1941?

A. No, he went in the Army about December. I think it was the 26th, some time after Christmas.

Q. What compensation were you paying him in 1941, do you recall? [161]

A. No, I don't. It was about the same as Petersen, wasn't it?

(Testimony of Ross B. Hammond.)

Q. About \$7,500?

A. Something like that.

Q. What was his job in 1941, before you entered into this so-called partnership agreement?

A. Well, one of his jobs was in Milwaukie, the Milwaukie Housing Project.

Q. The Milwaukie Housing Project?

A. Yes. I don't know what the job number was.

Q. That is Contract No. 207.

A. Okeh. From there he went to the Aluminum Plant.

Q. That was started in 1941, wasn't it?

A. Yes, and I think it was the next number, 208. I imagine there were some six or seven engineers under him, but his responsibility was to see that all the buildings were put in the right spots, both sideways and up and down, and it was a very important matter because the Aluminum Company also had a crew of engineers seeing to the same thing and——

Q. 208——

Mr. Bischoff: Let him finish.

Mr. Winter: I thought he had finished.

A. Well, I was trying to follow through. I think it was shortly after that that they pulled him into the Army.

Q. What time was it? Was it late in the year when they pulled him into the Army in 1941? [162]

A. I am pretty sure it was December 26th, because I think he had a chance to stay home for Christmas, and he was in Fort Lewis the next day.

(Testimony of Ross B. Hammond.)

Q. Then he got back about February 3rd?

A. Well, he was in there about a month.

Q. February 3rd you say you executed a partnership agreement? A. That is correct.

Q. On the same day you executed the two agreements with——

A. ——Mason and Petersen.

Q. ——Mason and Petersen?

A. That is correct.

Q. I will show you what has been marked for identification Plaintiff's Exhibits No. 4 and No. 5, and received in evidence——

Mr. Bischoff: We did not offer them in evidence.

Mr. Winter: You produced them as Plaintiff's Exhibits but you refused to offer them. Did you make an objection to them?

Mr. Bischoff: You have not offered them yet.

Mr. Winter: Yes, we offered them.

Mr. Bischoff: I have no recollection of your offering them.

Mr. Winter: If there is any question about it, your Honor, we would like to re-offer them.

Mr. Bischoff: At this time I object, as incompetent, irrelevant and immaterial and for the reasons previously stated.

The Court: Admitted, subject to objection.

Mr. Winter: Those are the agreements you had with Mr. Petersen [163] and Mr. Mason, are they not, Exhibits 4 and 5?

A. Yes, sir. This one is not. This is Exhibit No. 3. It is not Exhibit 4 or 5.

(Testimony of Ross B. Hammond.)

Q. I have 4 and 5 here. You might as well have all the exhibits. Exhibit No. 3 is the partnership agreement; Exhibit No. 4 is the Mason agreement and Exhibit No. 5 is the Petersen agreement. Is that right?

A. That is correct.

Q. They were all executed February——

A. ——3rd.

Q. February 3, 1942, is that right?

A. That is right.

Q. Where were they executed?

A. In my office, I presume.

Q. Who prepared them?

A. I believe Mr. Jacob.

Q. Mr. Jacob prepared them? A. Yes.

Q. There was also executed at the same time, was there not, a power of attorney which has been marked Defendant's Exhibit No. 30?

A. Yes, sir.

Q. Under the Petersen agreement, he was to get \$7,500 and under the partnership agreement your son was to get \$7,500 and a percentage of the profits, is that right? [164]

Mr. Bischoff: The contracts speak for themselves, your Honor.

The Court: He may answer.

Q. (Mr. Winter): Was it your intention, Mr. Hammond, Mr. Peterson was to get \$7,500 and your son was to get \$7,500.

A. They were each allowed to take \$7,500 as a drawing account.

Q. Why did he execute a power of attorney on the same date?

(Testimony of Ross B. Hammond.)

A. Because, as I remember it, there was a possibility that he was going to be away and, if there was any possibility, I had to have that power of attorney, in case it was called for, and the fact that I was being very particular that this partnership was not divulged, but in an emergency where I had to sign something I had to have a power of attorney on record in case something happened to him, which is always liable on construction work.

Q. Who was your bookkeeper?

A. February 3rd it was Miss Novak.

Q. Rosalie Novak? A. Yes.

Q. You told the Court that was an entirely secret document, that nobody knew about it. Isn't it a fact that Miss Novak executed it as Notary Public, this agreement as well as the partnership agreement and the power of attorney?

A. That is correct.

Q. Then she knew about it, your own bookkeeper? A. I doubt it. [165]

Q. She notarized them, didn't she?

A. That is correct. She had notarized a lot of papers that she does not know anything about, to my knowledge, and I am quite sure—I don't remember all the details as of that time, but in this particular case, I am quite sure, I would be very sure that she did not read this. All she needed to do was to notarize the signatures that were on it.

Q. You say, in connection with the partnership agreement, you did not inform your banker?

A. To the best of my knowledge, I never informed nobody but my son, my wife, and, of course,

(Testimony of Ross B. Hammond.)

I told Mr. Jacob. As I wanted him to write it, he couldn't very well write it up without knowing what he was writing up.

Q. You filed a certificate of an assumed name with the County Recorder, showing yourself as the sole owner of the business, and, when the Corporation was dissolved, you took all contracts in your own name individually? A. I did.

Q. You were general manager of all contracts except as you might consult with Petersen and Mason and your son?

A. I was the head of the organization.

Q. As a matter of fact, you had a power of attorney to handle all the business?

A. That is correct.

Q. Mr. Mason, he was in charge of one project as superintendent, [166] was he not?

A. He was.

Q. One or more?

A. Up until a certain time he was general superintendent.

Q. Mr. Petersen was also a general superintendent or manager?

A. He was a superintendent on individual jobs.

Q. As a matter of fact, your son was the superintendent on the Milwaukie Housing Project in 1941?

A. No; he was the engineer that was laying it out. I forget who was the superintendent on that job.

Q. Did he have a lot of engineers working under him?

(Testimony of Ross B. Hammond.)

A. Well, I wouldn't say a lot; three or four.

Q. He did not pay you any money for the one-fifth interest in the business? A. Not in cash.

Q. He gave you a note, didn't he?

A. Well, it seems to me he did. I can't remember. I can't find it.

Q. As a matter of fact, all the funds that he had was what money he had earned since he came to work for you since he had left college?

A. I certainly have no knowledge of what funds he had. I don't think he had very much money, if that is what you are getting at.

Q. As a matter of fact, you supported him in college? A. Yes, sure. [167]

Q. What management and control of the business did he exercise after February 3, 1942, that he did not exercise in 1941?

A. After he came back?

Q. Yes.

A. Well, his duties at that time—I believe we put him in charge of the Guilds Lake Project.

Q. When you say "we put him in charge," do you mean you and Mason?

A. I talk about the Ross B. Hammond Company as "we." It does not mean "it." I mean "we" because I was "it."

Q. You put him in charge——

A. I guess I am a little like Lindbergh, because I like to talk about "we," because we were all together and we operated all together. That is, Mason and Petersen and Bill and I ran this company, even though I was still boss.

(Testimony of Ross B. Hammond.)

Q. You were still in charge?

A. I was the executive head at the time and when Bill came back I put him in charge of Guilds Lake, which, if I remember right, was something like a million and some-odd dollars of a contract. It was several hundred houses, the first installation at Guilds Lake, for which he was entirely responsible. We had accumulated this University Homes Housing Project which was a five-million-dollar operation and 2,000 homes which they were trying to get ready for occupancy in ninety days, so I took Mason and put him out on that project and so Bill then took charge of the Guilds [168] Lake Housing Project and also helped me in the office because Petersen had his hands full at the Troutdale Aluminum Plant which was also quite a large job.

At the end of this Guilds Lake Project—I think it was not quite completed when they yanked him back into the Army. In the meantime, he had been under my wing pretty close because I was in the office and he was in the office with me. I felt Mason was capable of the University Homes and I didn't pay much attention to it. I felt Petersen was capable of building the Aluminum Plant and I did not pay much attention to him, but I did pay a lot of attention to the rest of it and I paid a lot of attention to Bill because I needed him.

Q. You were training him?

A. I beg your pardon?

Q. You were still training him?

A. I sure was.

(Testimony of Ross B. Hammond.)

Q. Are you still operating now as an individual or a partnership? A. As a partnership.

Q. Who prepared your income tax return for 1942?

A. Mr. Jacob and my bookkeeper have prepared all of them.

Q. Did Mr. Jacob prepare the return for 1942?

A. He prepared all of them.

Q. On that return you do not show any income from the partnership, do you?

A. I don't— [169]

Q. I will show you the return for the year 1942.

A. Is this the individual?

Q. On line 8 you show net profits from business or profession of how much? A. Line 8?

Q. I am looking at the wrong return. Pardon me. What do you show as income from your separate business?

A. Well, this is the return of Ross B. Hammond, individually.

Q. Yes.

A. On line 9 it says "Net Profit or Loss from Business or Profession," and it shows \$149,089.15. That is on line 9.

Q. There is no income shown from the partnership? A. No.

Q. Mr. Jacob, who prepared your return, knew about these agreements, didn't he?

A. I presume he must have. He made them.

Q. And it did not occur to you that it was a partnership return and you were reporting one-half of it?

(Testimony of Ross B. Hammond.)

A. No; as a matter of fact,——

Q. Or 75 per cent of it?

A. I didn't even know. I never had anything to do with making a return. When they told me it was a return and to sign it, why, I signed it.

Q. As a matter of fact, you did not file a partnership, a delinquent partnership return until May 15, 1944, isn't that right? [170]

A. If it says it there, it is right. If that is what it says there, it is right. This is Ross B. Hammond Company all right. There is no date on it. There is some receiving stamp here.

Q. You know that as a matter of fact you did not file it until you prepared your 1943 return?

A. I know all about it and I am trying to answer your question.

Mr. Bischoff: The return in his hand isn't dated. Have you got the original?

Mr. Winter: Yes, he has the original. It shows when it was stamped as having been filed.

Q. In your return for 1943, that is the first time you ever divulged to the United States or to anyone, outside of your wife and Bill, as you say, that any partnership existed, is that right?

A. That is correct.

Q. Although Mr. Jacob, who prepared the return, knew about it, and although your bookkeeper knew about it, that is, she notarized these agreements——

A. When you say that she knew about it, I don't agree with you. I agree with you that she

(Testimony of Ross B. Hammond.)

notarized them, but I am reasonably sure she did not know it because I am pretty sure I would not let her—I am quite sure I would not read it to somebody or let somebody else read it.

Q. You did not let her see it when she notarized it? A. I just—— [171]

Q. Except to put her signature on it?

A. I said, “Notarize these agreements.” They were all made out and were all ready.

Q. Was Bill there? A. Bill, where?

Q. Was Bill in the office when the partnership agreement was executed? A. Yes, he was.

Q. Would you look at the signatures on there, please. A. Yes.

Q. Do they appear to be signed with the same pen and ink?

A. No. I presume he had his own pen. I don't remember those details.

Q. Do you have any recollection that you were there when he signed?

A. I can imagine I was.

Q. You are just imagining? You don't have any independent recollection that you were there, then?

A. I would say I was, yes. I think it was signed right in my office.

Q. Did you have any other profit-sharing agreement with Bill during the year 1941 or 1942, other than this partnership agreement? A. No.

Q. You did not? You say definitely you had no other agreement, [172] profit-sharing agreement?

A. Not that I remember.

(Testimony of Ross B. Hammond.)

Q. Either during 1941 or 1942?

A. That is right.

Q. Did you have any in 1943?

A. No, I had nothing but this partnership agreement.

Q. I think you stated all your contracts with the United States Government were taken in your name, and you also stated that the reason why they were taken in your name was that Bill might not be available to sign any change orders or anything of that nature?

A. That is correct.

Q. You had his power of attorney, with authority to sign and take all contracts in your name?

A. Yes. This was for the reason that it was kept secret.

Q. Was that one of the reasons it would not be necessary to have Bill's signature on contracts, as long as you had the power of attorney? Even if the contracts were taken in the partnership name?

Mr. Bischoff: Objected to as argumentative, your Honor.

The Court: He may answer.

A. It was not the first time I had had Government contracts. In the first World War I was doing the same thing for another contractor, and there were complications that arose with the partnership when we would have Government papers to sign. They just led to more red tape than I have ever been able to get loose [173] from, and for that reason I kept it that way.

(Testimony of Ross B. Hammond.)

Q. Did Mr. Petersen know that in the conduct of the business your son was one of the partners?

A. They knew nothing.

Q. Therefore, he did not exercise any of the rights of a partner in that matter, as one of the bosses over them, over those individuals, did he?

Mr. Bischoff: Objected to as argumentative.

The Court: He may answer.

A. He didn't exercise any, no more than we had in our conferences before he went to war.

Q. He did not exercise any further control than he did in 1941 or 1942? A. No.

Q. He did not have the right to sign checks except with the signature of Mr. Mason or Mr. Petersen or some other one in authority in the office?

A. He had the same right to sign checks as Mr. Mason and Mr. Petersen, and they had to be signed with Miss Novak's signature. The only one in the outfit that had the right to sign a check alone was me, and that was for an emergency. It was rather occasional when I would sign a check alone. In fact, for years, ever since Miss Novak has been there, if it is at all possible, I insist on Miss Novak's signature on a check first, because she is the one that has the responsibility for seeing that the check [174] is properly made out. She and Bill can sign checks; she and Petersen can sign checks and she and Mason can sign checks.

Q. Your son had no authority to draw from the Corporation except to the extent of \$7,500 a year?

A. According to our agreement.

(Testimony of Ross B. Hammond.)

Q. It was the same arrangement, the same agreement that you had with Mr. Petersen and Mr. Mason?

A. As far as money is concerned, yes.

Mr. Bischoff: Objected to as argumentative. The contracts are the best evidence.

The Court: He has already answered.

Q. (Mr. Winter): As a matter of fact, your son did not include 25 per cent—Did your son include 25 per cent of alleged partnership profits for the year 1942 in his return? Did he?

A. I think the return was made up by the same people who made up mine.

Q. He only reported \$7,500.

Mr. Bischoff: Objected to, as the return is the best evidence.

Mr. Winter: If he knows.

A. Well, I don't know. Without the return I can't remember those things.

Q. (Mr. Winter): I have the return.

A. To answer your question, with the knowledge I have of it, I am pretty sure it was not, because the returns were made out at the same time by the same people for both of us. [175]

Q. Did you tell your son at the end of 1942 what his partnership profit was?

A. He knew at all times.

Q. What? A. He knew at all times.

Q. I am asking you if you told him?

A. I presume so, by the time we knew what it was.

Mr. Winter: I think that is all.

Mr. Bischoff: That is all.

The Court: We will resume at 10:00 o'clock in the morning.

(Whereupon, at 4:40 o'clock p.m., an adjournment was taken until 10:00 o'clock a.m., Wednesday, January 14, 1948.) [176]

Court reconvened at 10:00 o'clock a.m. Wednesday, January 14, 1948.

WILLIAM A. HAMMOND

was thereupon produced as a witness on behalf of plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. Will you state your full name?

A. William Allen Hammond.

Q. Where do you live?

A. I live in Washington County, Oregon.

Q. Are you married or single?

A. I am married.

Q. How long have you been married?

A. Six years.

Q. How old are you? A. I am thirty, sir.

Q. You are the son of Ross B. Hammond, the plaintiff in this case? A. I am.

Q. What business are you engaged in?

A. Building construction.

Q. With whom are you associated?

A. With Ross B. Hammond. [177]

Q. In what capacity? A. As a partner.

(Testimony of William A. Hammond.)

Q. When did you become associated as a partner?

A. We became associated as partners in February of 1942.

Q. I show you Plaintiff's Exhibit No. 3 and ask you if your signature is on that instrument?

A. It is.

Q. You signed it? A. I did.

Q. On the date that it bears? A. I did.

Q. Who was present when you signed it?

A. Miss Novak was present and I believe Ross B. Hammond was present.

Q. Mr. Hammond, I show you Plaintiff's Exhibit No. 2 and ask you if you received that instrument? A. I did.

Q. From whom?

A. From R. B. Hammond.

Q. When did you get it?

A. At the same time as the signature, on February 3rd.

Q. You got it at the same time that the articles of partnership were executed?

A. That is correct.

Q. Where were you born? [178]

A. I was born in Pittsburgh, Pennsylvania.

Q. When did you come to Portland, Oregon?

A. Well, I believe I first came here when I was about four years old. I was traveling with my family.

Q. Have you lived here in Portland ever since?

A. I have lived here, I believe, since I was five.

(Testimony of William A. Hammond.)

Q. Will you state what schooling you have had?

A. I attended grammar school in the City of Portland and some high school at Washington High School in Portland and graduated in La Jolla, California, and Culver Military Academy.

The Court: What kind of school is in La Jolla?

A. High school. I was down there when I was sick and I went to school for about four months there or six months.

The Court: How big a town is La Jolla?

A. I think about 10,000 people.

The Court: How far from San Diego?

A. About fifteen miles.

The Court: Which direction?

A. It is just north.

Mr. Bischoff: Q. You were there while you completed your high school studies?

A. Well, it was about my sophomore year. I was sick and had to leave Portland and go south for the temperature and warmth, and I went to school there just for the six months I was there, but I have been trying to give a complete account of the places [179] that I had attended school.

Q. You got credit for that?

A. I believe I got credit for what amounted to four units or six units of high school education. From there I went to Culver Military Academy.

Q. Where is that?

A. That is in Indiana.

Q. How long were you at Culver Military Academy?

A. Two years.

(Testimony of William A. Hammond.)

Q. What was the nature of the training or education you received there?

A. The training was college preparatory.

Q. From there where did you go?

A. I went from Culver to Stanford University in 1935.

Q. From what year to what year did you attend.

A. From 1935 to 1939.

Q. You graduated in 1939?

A. I believe I technically graduated in January, 1940, although I am not positive of the date. I would have to look at the diploma to see whether it was the 1939 class or the 1940.

Q. That is close enough, either the end of 1939 or the beginning of 1940 when you graduated.

A. I was home in January of 1940.

Q. Did you receive any degree upon your graduation from Stanford?

A. Yes, I received a degree of Civil Engineering. [180]

Q. What was the course of study you pursued at Stanford University?

A. Civil Engineering course.

(The Court proceeded to the transaction of other business.)

Mr. Bischoff: Q. Will you explain the nature of the course of study you pursued at Stanford University, particularly with reference to the type of engineering to which you channeled your course?

A. In college education for engineering you are required to study for not any one engineering de-

(Testimony of William A. Hammond.)'

gree. If it is Civil Engineering, a Civil Engineering degree, you still have to study all phases of engineering, mechanical, chemical, structural and so on and, to get any one of these degrees, you have to cover the entire field of engineering. It is a very broad field and requires physics, mathematics, laboratory, heat and power and field surveying.

Q. Did it include any special work with reference to construction engineering?

A. Well, to the best of my knowledge, there is no course prescribed for construction engineering, but it did include strength of materials and applicable studies.

Q. After your graduation from Stanford, did you pursue any further studies? Did you pursue any further studies in any educational institution?

A. No, sir.

Q. During the time that you were attending school, and up to the [181] time of your graduation from Stanford, had you formulated any determination as to the occupation or business or profession that you intended to follow?

A. I had definitely decided, quite some time before that, that I was going to be in the building construction business, even to the extent that I had had many discussions with my father about it, and in the earlier stage he attempted to discourage me. I had my mind made up that I was going to Peru. As a matter of fact, before I even started to college—I believe I was sixteen—I went to work for

(Testimony of William A. Hammond.)

another contractor, and that is when my father said if I was going to work in that business he was the best man qualified to teach me and certainly the most interested in doing so.

Q. How early was it, if you can recall, that you made that determination?

A. I would say I formed that determination when I was about twelve years old. It was prior to Culver and prior to my sickness.

Q. Was that determination a subject of frequent discussions with members of your family, with your father and mother?

A. Yes, it was.

Q. Did that determination have anything to do with channeling your course of study?

A. Very definitely channeled my course of studies.

Q. Did you do any work during the period of time that you were [182] attending school, that is, when you had other time available or during vacation time from your studies?

A. I worked practically all of every vacation from the time I was sixteen in the construction business.

Q. Always in the construction business?

A. Yes, sir.

Q. I will talk about the period up to your graduation. I will talk about the subsequent period later.

During that period, whenever you had work, was it always for your father or with your father, or did you work elsewhere?

(Testimony of William A. Hammond.)

A. Well, I was with my father exclusively with the exception of about—I believe there was one month where I worked for—I can't even recall the name of the organization. It was one with which my father was associated and in which I was very interested in the plant. I believe it was known as the Oregon Housing Corporation.

Q. And that was in the early years?

A. That was when I was still in college and I wanted a paying job and there was about thirty days left before going back to school.

Q. Will you describe the kind of work you were doing in this preparatory period from the early time on, in a general way?

A. My first job was as a regular laborer on a construction job, wheeling concrete and carrying lumber, and in doing so I learned the sizes of nails and about boards and steel, inasmuch as I had [183] to find it to take it to the various places and, to get what was called for by name, I learned the vocabulary, you might say.

Q. Is there an unusual vocabulary as to materials in the construction business?

A. Yes, there is, quite, and from that I also kept time and posted it to what we call our job cost and, at the same time I was doing that, at night and at home and on week ends my father was explaining the interpretations of what I was doing, so that later on I could analyze costs by the unit, and I went from that and was doing time-keeping and labor and occasionally, on Saturdays,

(Testimony of William A. Hammond.)

I was in the office, where I found out how the costs were transferred into billings, and I assisted them in that way in the office.

Q. During all of that time, were you doing that under the supervision of your father?

A. I was under his constant supervision from a very early age.

Q. Was he actively directing you?

Mr. Winter: I think we are entitled to an objection on the leading questions. It has been going on now for some time. I think that we are entitled to an objection and ask that the answer be stricken as leading.

The Court: Ask him another question.

Mr. Winter: Exception.

The Court: What do you mean, "exception"? Mr. Winter, keep yourself in check. In the first place, exceptions are not necessary [184] or allowable under our practice. You are just as big an offender at leading questions as is Mr. Bischoff.

As a matter of fact, when we try cases without a jury, it is entirely within the discretion of the Court as to the extent suggestive or leading questions are permissible. Try to avoid them, however, Mr. Bischoff.

Mr. Bischoff: Q. State what your father did in connection with teaching you the business?

A. Well, to make that concise, he continuously worked with me and checked my work, not for technical addition and subtraction, but for the principles upon which I was working, and he

(Testimony of William A. Hammond.)

would query me quite frequently nearly every time we were together, which was at least every other day, about how I did something and why I did it and where I did it and when I did it and then, when my answers were what I would consider now not quite satisfactory as far as detail and as far as knowing specifically are concerned, why, when I didn't answer the questions to his satisfaction, usually he made me go back—Rather than tell me the answers, he made me go back and think about it for a day until I did pick it out myself. If I failed to, then he would prompt me a little, but his method of training has always been one in which he made me do the work and continue to do the work until he was satisfied I knew what I was doing.

Q. In the various jobs you were assigned to, was this done with relation to the training program that you were undergoing? [185]

A. All my work prior to that time was in the matter of training. I had a very short time to pick things up. I had to move fast, and I was told at the very beginning—I believe Dad's statement specifically was that he had to teach me in five years what it took him thirty-five to learn, and I was getting it thrown at me just as fast as he could.

Q. During that same period of time—I am speaking about up to the time of your graduation—had there been any discussion between you and your father and your family with respect to your ultimate association with your father in business?

(Testimony of William A. Hammond.)

A. Well, there had, but we did not always exactly see eye to eye.

Q. What was the nature of the discussion in that respect?

A. The nature of the discussion was that I did not particularly like being the boss' son, and I had decided that I could go it pretty well for myself, and I do not mean it in any cocky sense, but I just wanted to keep from being Ross Hammond's son on the job, and I had discussed the idea, and very much so, of going to Brazil, which I considered more or less the Pacific Coast of his day. He had come out to the Pacific Coast when he was about my age, and I had thought that Brazil was in a position to become an engineer's country and that I might go down and get in on the ground floor and start working in my own company.

Q. Was that what you were telling your folks in these discussions? [186]

A. I was telling my folks that and I was discussing it with my then bride-to-be.

Q. What was your father's reaction to the program then?

A. Well, we carried out these arguments for quite a while, quite some time. His principal argument was that I was being quite foolish to throw away my associations up here in a company which he had started and which was organized.

The Court: Don't go into that too much.

A. I beg your pardon.

The Court: I was talking to Mr. Bischoff.

Mr. Bischoff: Q. At any rate, in these dis-

(Testimony of William A. Hammond.)

cussions was the subject of a prospective partnership involved? A. Yes, sir.

Q. After you had agreed to stay, what was done?

A. Well, I continued with the same type of education, advancing more rapidly since I had more time and since the operations were more continuous.

Q. Did you then take steady employment?

A. Yes, I took steady employment immediately.

Q. With whom?

A. With Ross B. Hammond.

Q. You have been associated with him in the same capacity ever since?

A. Yes, sir, I have, other than my sojourn in the Army.

Q. State what you did from the time of your graduation, generally, [187] the nature of the work from the time of your graduation to the time the partnership agreement was formed.

A. Well, the nature of my work was as time-keeper and as engineer on the Milwaukie Housing Project and as project engineer at Troutdale.

Q. How big a job was the Guilds Lake Project?

A. The Guilds Lake Project was 358 homes and the total contract was about \$1,142,000, I believe.

Q. You engineered that job?

A. Yes, sir, I did.

Q. Did you do that all alone or did you have a staff of engineers under you?

(Testimony of William A. Hammond.)

A. Well, I had a staff of engineers under me at that time. The actual layout and engineering of Guilds Lake came at a time after I had become a partner and I was frequently acting as Ross Hammond's assistant, inasmuch as Mr. Mason and Mr. Petersen were both out of the office.

Q. I think you said you went into the Army. Will you state when you first went into the Army?

A. I first went into the Army December 26, 1941.

Mr. Winter: What is that date again?

A. December 26, 1941.

Mr. Bischoff: Q. How long did you remain in the Army?

A. At that time I was released on January 20, 1942.

Q. Did you have a commission at that time?
[188]

A. Yes, I had a Reserve Officer—I had been a Reserve Officer for several years.

Q. What was your commission?

A. My commission was Second Lieutenant in Field Artillery.

Q. Why were you released?

A. Well, I have no eardrum in my right ear, and I have a paralysis of the seventh cranial nerve, I believe it is called.

Q. What did you do after you were released from the Army?

A. I returned immediately to Ross B. Hammond's employ, where we had considerable jobs.

(Testimony of William A. Hammond.)

As a matter of fact, I was advised of my release January 5th, I believe, or 4th, and from the 4th to the 20th we were in telephone contact almost daily with regard to the jobs that I knew about and, as soon as I realized that I could not get in, rather than put somebody else on them, we stayed in telephone contact as to them from day to day.

Q. What precipitated the discussion that culminated in the making of a partnership agreement on February 3, 1942?

A. Well, the truth of the matter is that it had been previously discussed and I had—As I recall the situation, I had gotten perturbed at the war and Dad and I had been discussing these contracts with Mr. Mason and Mr. Petersen, and he had been discussing the partnership with me, and the war came and I just told him more or less to go to, that I was going into the service, and we had quite a fight, because he had contacted Senator McNary with regard to my staying out. I could have [189] stayed out.

The Court: Don't go into that, Mr. Bischoff.

Mr. Bischoff: Q. You don't need to develop that in detail. I just want to get what precipitated the making of the contract at that particular time.

A. My return from the service, I believe, did. He said he would like to have me sign up then so I said I would go along with it.

Q. Did you enter into that partnership contract with your father in good faith, intending to be a partner with him? A. Very definitely.

(Testimony of William A. Hammond.)

Q. From that time on, after that contract was made, was the scope of your activities any different or greater or less than it had been before?

A. They were very definitely greater. I had complete scope of activity after that.

A. Will you state briefly and to what extent, what your activities consisted of and to what extent they were greater than theretofore?

A. Well, I was completely handling Guilds Lake which was my sole responsibility and, in addition, I believe that we had about three other jobs or four other jobs, exclusive of Troutdale and University Homes, each of which were directly supervised by Mr. Petersen and Mr. Mason and, in addition, I took care of Troutdale as far as preparing office billings that were submitted [190] by Mr. Petersen following the estimates having been made on the job; they were submitted to the office for billing and I checked the billings and assisted the clerks in getting out definite bills.

Q. Will you please describe generally how estimates were prepared for allowance by the engineers or other offices, and how they were billed out to the Government or other agency?

A. Well, may I ask you to clarify the question? Guilds Lake, for instance, was a lump-sum-bid job and Troutdale was a unit-price job.

Q. Well, describe what you did and how the billings were made for each type of contract. You need not take each individual job, but individual type of contract.

(Testimony of William A. Hammond.)

A. Guilds Lake was a typical lump-sum-bid job. I went out on the last day of the month and determined, in my own opinion, the monetary value of the work on the job and that which we would be paid for. Some of it was not on the job. We had work in Albany, for example, the fabrication of homes that were going up there and the plant in Albany needed to be paid for it, although it had not been put up on the site, and we obtained forms from the FPHA to bill that on, along with the actual foundation, plumbing, sewers, streets and so forth.

Q. At any rate, you accumulated the information you needed to enable you to determine that?

A. I accumulated all the information to determine the monetary [191] value of that work and then obtained the approval of the architect, obtaining a certificate on it, and then obtained the approval of the FPHA itself, and then it was submitted and went through to Washington, on that type of job.

Q. Before it was sent in for payment, was it billed out in the office, after you obtained the approval of the amount by the Engineers?

A. We billed it out on the specific forms for payment by the Government.

Q. After the approval? A. Yes.

Q. You billed just the amount that was approved?

A. That is all we could bill. That is all that would go through. On that type of job, Mr. Peter-

(Testimony of William A. Hammond.)

sen did the preliminary work that I discussed, that I did on Guilds Lake, out at Troutdale, and then those figures were sent in to our main office where I checked them against our bills to make sure that we were getting sufficient money and that we did not leave out something that we had paid for, and then prepared the bill and sent it through channels.

Q. In those cases there was the requisite approval by engineers or other officers?

A. Yes. It was necessary, in the course of completing this billing, to visit these jobs, including Troutdale.

Q. Was that the plan that was uniformly followed in billing [192] for work done?

A. Well, it is in general the plan I always followed.

Q. Was it followed in your business?

A. Yes.

Q. In accumulating the information upon which you estimated the amount to be billed, did you include materials that had been purchased for use on the job?

A. Yes, in every case, to the best of my knowledge. In general, we would collect for items that were referred to as "on site" unless there was a specific clause in the contract which said that "payment will be made only for material incorporated in it," and, to the best of my knowledge, we had no such contract.

Q. Were there any reserve materials on any of these jobs that were not included in your monthly estimates?

A. No.

(Testimony of William A. Hammond.)

Mr. Winter: Object to that, if Your Honor please, as being a conclusion. If there were any such inventories taken, they would be the best evidence. I think it is admitted here that no inventories were taken, and the books do not reflect it.

The Court: The witness may go ahead and answer the question. You know what the question is here about inventories. You have heard it for two days now.

A. In my opinion, there weren't any inventories because of the fact that we billed all materials which we had on the site at every job. We submitted a bill, and in the form of the bill you [193] worked out the amount of money in each instance and then, as an item, included the materials stored on the site; for example, we included the materials stored at Albany that were all prefabricated; they were approved for payment.

Mr. Bischoff: Q. In other words, the billing included all the materials that you had?

A. All the materials and of the types of contracts we had on hand, to the best of my knowledge—that type of contract in which they said “incorporated in the work,” I have not seen one and I haven't signed one.

Q. I omitted something I should have asked you before. You went back into the Army, didn't you, at a later date? A. Yes, I did.

Q. Will you please state on what date you went back into the Army?

A. I think it was October 16th.

(Testimony of William A. Hammond.)

Q. Of what year? A. 1942.

Q. When were you discharged?

A. December 28, 1945.

Q. When you were discharged, what did you do?

A. I returned immediately to Ross B. Hammond Company.

Q. During the time you were in uniform the second time, from October, 1942, to December, 1945, were you overseas or were you in this country all the time? [194]

A. I was in this country all the time.

Q. Were you back home on occasion?

A. I was back there approximately every six months.

Q. Did you keep in touch with your father regarding business matters during the time you were away?

A. We were in constant touch. We met either when I was home on leave or when he occasionally flew down to meet me to discuss matters. When I would transfer, we would arrange to meet between places so we could discuss it, and we carried on frequent telephone conversations.

Q. Was there always correspondence between you?

A. Yes. A majority of the work, however, was discussed by phone because of the length of time involved in correspondence.

Q. Were those business discussions?

A. They were all business discussions.

(Testimony of William A. Hammond.)

Q. Did you get any information about the business or financial affairs of the business?

A. I got continuous information in regard to our financial affairs.

Q. When the partnership was formed, was there any understanding as to whether the partnership was to be made public or whether it was or should be kept secret?

A. We definitely understood that it was to be kept secret.

Q. Do you know the reason for it?

A. I know all the reasons for it. [195]

Q. Were you in court when your father testified as to the reasons for secrecy? A. Yes, I was.

Q. Did you hear what he said about that?

A. I did.

Q. Were those the reasons that induced the maintenance of secrecy?

A. They were. As a matter of fact, I was just as vitally concerned as he was with regard to the other members of the firm knowing about it.

Q. When you became a partner, did you become aware of the manner in which the books of account were kept, or the accounting method?

A. Well, I am somewhat like my father in that I am not an accountant. I think I understand books even a little better than he does, but I am certainly very far from being able to pick up a set of books and understand them. If I sat down and really dug, I could pick out the information, but I am not generally familiar——

(Testimony of William A. Hammond.)

Q. What I would like to know particularly is: Did you become aware as to the particular system of accounting, the method of accounting that was being employed?

A. Yes, I was aware of our system.

Q. What method did you understand was being employed?

Mr. Winter: Object to that, if Your Honor please. The witness says he does now know anything about accounting; he just [196] knows about it in a vague way.

The Court: Answer.

A. It was explained to me that it was an accrual system, and I asked enough questions to find out what an accrual system was. My ability to interpret the details of bookkeeping was vague but my comprehension of the principles, I believe, was correct.

Mr. Bischoff: Q. Did you know that securities had been purchased with firm funds in the name of your father, individually?

A. I was well aware of it.

Q. Were you informed of that by your father?

A. I was informed of all the purchases and sales and values and changes in capital value.

Q. Did you know what was being done with those securities?

A. I knew what was being done with those securities.

Q. Do you know whether they were being used as collateral in financing the operation?

A. Yes, they were.

(Testimony of William A. Hammond.)

Mr. Winter: I submit that is certainly leading.

Mr. Bischoff: I will withdraw the question.

Q. State, if you know, what was being done with the securities.

A. I know what was being done. In our type of business, it is constantly necessary to have collateral to use for bonding and, in some cases, to use this collateral in the bank actually to meet your payrolls. Your situation may well be one in which you have a lot of assets but you must be able to turn them into cash [197] to use to carry your payrolls and your material bills until such time as the money is coming back in.

Q. You were aware, during the years 1942 and 1943, that your partnership interest had not been reflected on the books of the company, as they were being kept at that time?

A. No, I was not aware of that.

Q. Did you have anything to do with dictating the manner in which the accounts would be kept?

A. No. The only thing I got were reports and direct answers to questions which I asked with regard to the financial status and our job status and material status and the contracts.

Q. Did that include information as to the amount of your share of the interest in the business?

A. Yes, I knew what my shares were but I did not know what the details of the books were. I got what might be a financial statement rather than the details of the books.

(Testimony of William A. Hammond.)

Q. You are familiar with the operations that went on under Contract No. 208, the Troutdale Aluminum Plant? A. Yes, I am.

Q. The books of the company disclose that in 1942 there was \$10,056.55 of income from that contract with costs in that year of \$1,057,409.83, with a net loss for that year. Are you familiar with conditions which prevailed on that job and which account for that situation?

A. I am very familiar with that particular phase. [198]

Q. Please state, if you can, without going into too much detail, what produced that condition?

A. Well, frequently the unit cost at Troutdale of the concrete—we had a definite price per yard of concrete, unit price per yard, based on 30,000 yards of concrete and, consequently, during the year, we charged for our overhead and our materials and forms and so forth to 30,000 yards, which was what we had been given to believe was the amount that was to be involved. That was already twice the amount we had figured, but we had been led to believe there would be 30,000 yards, and we followed the unit cost as we proceeded with the job.

Q. That is, for billing?

A. For billing and also for our own analysis. Our superintendent and myself continuously make analyses as to how our unit costs are doing, and, that was in 1942, both Mr. Petersen and myself

(Testimony of William A. Hammond.)¹

informed Ross Hammond that we were actually losing money on the Aluminum Company job and would lose money unless we ran over 30,000 yards of concrete, and it was after I left, when they finally computed the books—but I remember and distinctly recall at that time the analysis was that we were going to lose money on the job.

Q. That was due, was it not, to the necessity of spending all the money in preliminary work and the furnishing of equipment?

A. It is not only equipment but the forms. We built forms for the pot room, we built forms for the ore bin, and then these [199] forms were changed. When we got about halfway through we realized that we were not going to come out on it. It was just a case of having given too low a figure for the job of 30,000 yards. If it went the way it was supposed to, we would have lost money on the job.

Q. Did you ultimately get an increased amount, get an increase in the amount of yardage?

A. Increased yardage was gravy, as far as the forms were concerned and as far as the equipment was concerned, because they were already fabricated and had just been charged to the supposed 30,000 yards and, as I say, it may be termed gravy, when it went beyond the original idea.

Q. Would you say whether that would account for the profit that was reported in 1943, reported in 1943 for 1942?

(Testimony of William A. Hammond.)

A. Yes. As you heard me state, I left in 1942 but, on my last analysis, we were losing money on Job 208. It was after I was again in the service and got reports from Ross B. Hammond that I realized that we were doubling the job, almost, in quantity, and, therefore, our overhead remained constant and we were going to come out of that all right the next year.

Mr. Bischoff: You may cross-examine.

Cross-Examination

By Mr. Winter:

Q. As I take it, you went to work for your father when you graduated from school in 1940?

A. The spring of 1940. I had worked for him prior to that.

Q. I mean, after you graduated from college?

A. Yes, I believe so,—I believe it was January, 1940.

Q. After you received your degree in Civil Engineering?

A. That is correct.

Q. What was your work with your father during that time, that year?

A. During the year 1940?

Q. Yes.

A. I was timekeeper and assistant to the superintendent for the Clark County Court House.

Q. Who was superintendent of construction of the Clark County Court House?

A. Mr. Petersen was.

Q. Mr. Mason was also associated with your father at that time?

A. Yes, he was.

(Testimony of William A. Hammond.)

Q. What was your work in that connection? What were your duties?

A. My duties were keeping track of the time on the job, the materials delivered to the job, assisting in scheduling of deliveries, and assisting in work to be done the following week and the following month; in other words, progress layout.

Q. In preparing estimates, too?

A. I assisted Mr. Petersen in that, at the end of each month.

Q. Was that the only job you worked on in 1940?

A. No. I believe that that job at Milwaukie started in 1940, [201] but I don't know definitely, but I think it was a defense housing project at that time. We were not at war and that is why I am inclined to believe that started in 1940.

Q. Was that Milwaukie Housing Project a cost-plus-fixed-fee contract or a lump-sum contract, or what kind of a contract was that?

A. I am quite certain that was a lump-sum contract.

Q. Are you familiar with the provisions of the Government with respect to lump-sum contracts?

A. Somewhat familiar. I would want to read it at any time that I was going into it again.

Q. Under these contracts, that type of contract, the Government, as the owner, makes partial payment as the work progresses upon application of the contractor and certified to by the architect-engineer; payments to the contractor are 90 per cent of the labor and materials incorporated in the work at the end of each billing period, is that right?

A. I don't know. You read it, sir.

(Testimony of William A. Hammond.)

Q. Is that a usual term of these contracts? Did you read it?

A. I don't recall it as a usual term of the contract. It is a standard form of contract but I don't recall it as a usual term.

Q. In other words, an estimate would be made at the end of the month, or some time during the month, of the value of the labor and materials incorporated in the work, and you would bill them for 90 per cent of that amount, would you not?

A. You bill them for all of that and then the retained percentage is retained as prescribed in the contract. Those things are specifically covered in the individual contract, and to know what it was on that particular job I would have to read that particular contract.

I believe, as I have already stated, that we collected for materials, as I remember, "suitably stored on the site."

Q. How do you account for the fact that, in connection with the Troutdale Aluminum Plant, you only accrued \$1,036,623.10 but yet had a cost of \$1,057,409.83? How do you account for that if you were able to bill for all of the materials you had purchased and which had accrued on the job?

A. That was a unit-cost job and if we gave a price of—

Q. I am talking about Troutdale. Only part of it was a unit-price job, was it not?

A. Well, this part you are referring to, that was a unit price, so many dollars per cubic yard of

(Testimony of William A. Hammond.)

concrete, and it cost us more per cubic yard, more per unit, than we could bill.

Q. Would you say you had any materials that were not taken into consideration by the taking of an inventory of materials on hand, or cement, or the amount of work which you could not bill at the end of the year, as your father said?

A. There was no definite inventory made, no, but we billed for all the material on hand that we could collect for.

Q. You accrued all the material which you had purchased regardless [203] of whether it was in the job, delivered, or not?

A. I don't quite follow your statement.

Q. Didn't you accrue the material which you ordered on the job?

A. Not unless it was delivered or we had paid for it. If it was in our office as an invoice, it was accrued because, if it was invoiced, it was delivered, but not if it had been ordered. We might order something and it would be two months before we got it.

Q. Were all the billings made at the end of the month, or would they be made at various times during the construction period?

A. In most cases, our billings were made at the end of the month, unless it was on a specific job and then it might have been, on occasions, submitted in the middle of the month, but generally it was the end of the month that the billings were made, in all of our operations.

(Testimony of William A. Hammond.)

Q. When you were making your estimates to submit to the engineer, the Government engineer, the owner's engineer, or architect, did you make any record of the materials on hand or any estimate as to the work which was completed for which you could not make any billing at the end of the year 1942?

A. I couldn't say exactly at the end of the year 1942, because I was in the Army at that time, but it was not our practice to make any inventory. It was our practice, however, to bill an individual job for materials, as I said, suitably stored on the site, in addition to those incorporated in the building. [204]

Q. That is to say, 75 per cent of the materials stored on the site the first day of the month, as estimated by the architect-engineer, is that right?

A. Are you reading from another contract?

Q. Yes.

A. In that contract, it may be. I would have to check the specific contracts that we had on any one job.

Q. Wasn't that a general provision of all Government contracts on lump-sum jobs?

A. I don't know whether you read two different paragraphs.

Mr. Bischoff: Counsel's question is confusing.

The Court: Don't interrupt. I don't want any interruption.

Q. (By Mr. Winter): You never billed for 100 per cent of labor and materials, either stored or in

(Testimony of William A. Hammond.)'

construction, at any time under lump-sum contract, did you, because each contract provided you could not bill for that, isn't that right?

A. In nearly every case, you billed 100 per cent and then they allow you whatever retained percentage is called for.

Q. You got a net of 80 or 90 per cent?

A. Whatever the contract might provide, depending upon the individual contract.

Q. Do you know whether you accrued the whole 100 per cent on your books, or the amount which you were legally authorized to bill for?

A. I do not. [205]

Q. You don't know that, do you?

A. I am afraid I don't.

Q. No inventory was made of materials remaining at the end of the year as to work which was incorporated in the building, for which you could not make any billing?

A. Inventory of work incorporated in the building?

Q. No appraisalment of work incorporated in the building was made at the end of the year?

A. No, nothing other than the amount we billed for; that was all that we could charge.

Q. In the construction business there are a lot of costs in connection with preparation, getting equipment and all that sort of thing, all those costs that are involved in the construction business?

A. Yes.

(Testimony of William A. Hammond.)

Q. They are not reflected in any structure that may be erected; they are in preparation?

A. Quite frequently they are reflected. As a matter of fact, in breaking down your estimate, you charge those things which are necessary for preparation into your earliest stages of construction and most architects and most engineers recognize them as legitimate costs at that stage.

Q. Did I understand you had charge of the Milwaukie Housing Project?

A. No, sir. I was engineer of the Milwaukie Housing Project. [206]

Q. How do you account for the fact that you show on your books income of \$7,634.09 and a profit of \$7,058.97, practically the same amount of profit that you had income? Did you make 100 per cent profit on that contract?

A. What?

Q. In 1943?

A. As a matter of fact, that contract was a hundred or several hundred thousand dollars and \$7,000 would not be 100 per cent profit, so I don't understand.

Q. You reported in 1943, on your alleged partnership return, that you had an income for that year from that job of \$7,634.09.

A. Yes.

Q. And that you had total costs of \$7,058.97.

A. That would not leave 100 per cent profit.

Q. I mean, a profit of \$7,058.97 and costs of \$575.12.

A. I know the issue you are making there, sir, but that was the end of a total contract which, as

(Testimony of William A. Hammond.)'

I understand it, we had billed up to that time. I assisted in preparing the original estimate. It is general practice to bill everything that we can get in a lump-sum contract. If the architect does not allow that, we have no way to show it. Our costs are not determined by our estimate. Our costs are determined by what we pay, and the amount we can collect is reflected by the architect's estimate.

Q. Your costs are determined, then, by the full amount of materials which you have ordered, whether on the job or not or [207] whether it is there at the end of the year, labor costs and overhead——

A. If we have paid them, they are.

Q. In other words, the costs are accrued, but the amount of income is not all accrued at the end of the year, is that right?

A. I don't follow your statement.

Q. You accrued costs of \$575.12, and you show a profit of \$7,058.97. In other words, you have a profit of over \$7,000 on costs of \$575.12.

A. To the best of my knowledge the \$7,000 pertains to the total contract which we had been unable to collect because we had been unable to obtain a certificate for that. They claimed it was work we had not done, and this was an estimate of \$7,000-odd work we had not done, according to them. As a matter of fact, we thought we had complied with the contract in toto but they said they would hold up an amount equal to \$7,000, so we did the work and it happened that the costs were \$500, but they were

(Testimony of William A. Hammond.)

compelled by the contract to pay us the amount of our lump-sum contract. Is that a clear answer?

Q. In other words, the work for which you received \$7,634.09 was done in 1942, the actual construction work? A. No, it had not.

Q. What?

A. No, it had not. There was part of the contract—For instance, a lump-sum contract is \$100. It does not matter how much [208] money I spend. I might have to spend \$150,000 or I might have to spend \$30,000, but they have to pay whatever the contract price is. They took exception, and that is what happened in that case. They took exception that we had not completed the work and we believed we had.

Q. That represented the retained percentage of contract work that had been performed?

A. I couldn't tell you for sure whether it was a retained percentage or just the fact that the architect did not certify it because he thought there was \$7,000 more work to do. We didn't think there was that at all.

Q. In any event, was that a lump-sum contract?

A. I believe it was. I would have to check the language of the contract to be positive.

Q. You were only paid on those kinds of contracts, that type of contract, 90 per cent of the labor and materials incorporated in the work, and 75 per cent of materials that were stored on the job, up until the completion of the contract, is that right?

(Testimony of William A. Hammond.)

A. I have said several times I don't know. There are different contracts. It might have been 90 and 75; it might have been 85 or 80—it depends on the particular contract. If it is part of the records, you can check it.

Q. In any one of the contracts did they pay the full 100 per cent? Were you entitled to bill for the full 100 per cent without discount? [209]

A. There may have been one or two that were 100 per cent. It is not common to have a 100-per-cent payment.

Q. Most of your contracts were with the Government? A. Yes.

Q. I mean, your large contracts?

A. Yes; as a matter of fact, they were.

Q. All Government contracts, however, provide that only 90 or 85 per cent, as the contract may be, would be paid upon an estimate being submitted?

A. Normally that is the situation.

Q. You think possibly you may have been working on the Milwaukie Housing Project during 1940?

A. I am not positive of dates. That is seven years ago.

Q. Did you start to work on the Milwaukie Housing Project in 1942 after you got back from the service?

A. No, I did not. When I got back from the service, January 30, 1942, I handled, I believe, the tail end of Milwaukie as assistant general superintendent, not directly on that job.

(Testimony of William A. Hammond.)

Q. Who was in charge of that job, Petersen or Mason?

A. I believe one of our other superintendents.

Q. For the year 1941, when you worked, you worked for a salary for your father, did you not?

A. In 1941?

Q. Yes. A. Yes, sir. [210]

Q. And he paid you a salary of \$4,626.76 for your services during that year up until the time you went into the service, is that right?

A. I presume the figure is correct.

Q. Then, again in 1942, when you came back from the service, you were put on a salary of \$7,500 a year, were you not?

A. Yes. Listen, I was not. I was put on a drawing account of \$7,500.

Q. Whether you call it a drawing account or not, that was the amount that you were allowed to withdraw from the so-called partnership?

A. That is right. I drew it monthly in the same category as salary, but it was a drawing account and distinctly understood.

Q. Are you familiar with the books to the extent to know whether or not there was any capital account set up on the books for yourself as a partner?

A. No, I am not familiar with it. I was getting reports as to my standing.

Q. You did? A. Yes, I did.

Q. When did you get your report as to your standing?

A. Well, I got reports, as a matter of fact, whenever I asked for them, but I got one at the end of

(Testimony of William A. Hammond.)

the year, rather, about February, as to what the status had been on December 31st.

Q. December 31st, 1943? [211]

A. Every year.

Q. I mean 1942. We are talking about 1942, now.

A. I got a statement.

Q. You filed an income tax——

Mr. Bischoff: Don't you want an answer to that question?

Mr. Winter: I thought he had finished.

A. I got a statement of where I stood financially every year, and that would include 1942.

Q. When you filed your return March 15, 1942, you reported your partnership, did you?

A. Well, I don't know. I am like Mr. Hammond. I relied upon the bookkeeper and counsel to prepare what I should submit to the Government.

Q. You are a college graduate, aren't you, Mr. Hammond?

A. I am.

Q. And when it shows in line 1 "Salary or other compensation for personal services," wouldn't you consider that to be partnership income?

A. If I prepared my own personal statement, personally, I would spend a great deal of time reading it.

Q. You signed that return, didn't you?

A. Yes, I did.

Q. You were interested in the amount of taxes you were going to pay or going to be required to pay Uncle Sam?

A. Yes, I was. [212]

(Testimony of William A. Hammond.)

Q. And you were interested in making a correct return? A. Yes.

Q. Weren't you? A. Yes, sir.

Q. If you were not making a salary but if you were receiving it as partnership income, would you be interested in showing it as partnership income?

A. I don't know how to answer that question without adding to it that I was in the hands of what I believed was good counsel, and they were preparing the returns for me to sign; they were very familiar with our books and——

Q. Did you intend to keep this partnership a secret even from the Government?

A. I don't believe that we thought of it in those terms we had been so concerned with our organization and——

Q. You had given your father, February 3, 1942, a power of attorney? A. Yes, I had.

Q. And you understood he was going to run the business under that power of attorney?

A. No, sir.

Q. Did Mr. Mason or Mr. Petersen know you were a partner February 3rd, 1942?

A. No, they did not.

Q. What did they consider you, as still a son of the boss? [213]

A. They may have. I was much more concerned with retaining them.

Q. You assumed no more responsibility, so far as they were concerned, or so far as anyone else was concerned, other than your discussions with your father after February 3, 1942?

(Testimony of William A. Hammonnd.)

A. Prior to the partnership, they had the same relationship. As his son I was able to give orders. I did not go around doing so, but I had the authority to.

Q. Was there any difference between your relationship with Petersen and Mason after February 3, 1942, than there was before?

A. There was considerable difference in that prior to that time Mr. Petersen and Mr. Mason had been in the office, and at the time we made this other arrangement, they were called upon to be out directly on their jobs, and it didn't require that I have the same relationship. I immediately stepped into the office from which they had been removed and I became general superintendent in fact——

Q. Did they understand that there had been a change in your relationship with your father? They didn't know that there had been any change?

A. We certainly didn't want them to know it.

Q. You certainly did not want the bank to know it, either?

A. Well, the principal reason for that was that then Mr. Mason would know it.

Q. You knew the contracts were being taken in your father's name, [214] individually?

A. Yes.

Q. And you knew an assumed business name certificate was filed with the County Recorder in the name of your father, individually, as the owner of the business?

A. I didn't think of that particular subject.

(Testimony of William A. Hammond.)

Q. As a matter of fact, you didn't need to tell anyone of the secret arrangement except your father and your mother?

A. We have said that, that we tried to keep it secret.

Q. Who were present when Mason's and Petersen's agreements, Exhibits 4 and 5, were executed?

A. I believe that all of these agreements were executed on the same date in the same office, and that I was there, probably. It might have been I was in the next office and they executed them, but I saw them immediately after their execution.

Q. Were you present when Mr. Petersen and Mr. Mason signed their agreements?

A. I couldn't swear to it.

Q. Were they present when you signed this so-called partnership agreement?

A. I am quite positive they were not present when I signed mine because I was definitely trying to——

Q. Did you give them to understand that you also were on a profit-sharing arrangement?

A. I didn't give them to understand anything. That was none [215] of their business.

Q. They had access to the books and accounts?

A. I know that they had access, but we were not—we had tried to keep the partnership out of anything that they had access to.

Q. If you changed and assumed a different managing position after February 3, 1942, that at least was not told to Petersen and Mason?

(Testimony of William A. Hammond.)

A. Circumstances were such that their conditions changed, too. Mr. Mason, for example, had been general superintendent of Ross B. Hammond Company, and at this time he was not even acting as that. He was superintendent of a very large job. He had changed his capacity completely which made it unnecessary for us to inform him of anything. They were both taken out of the office which gave me a chance to assume duties and responsibilities of a partner and general superintendent without having to confer with or advise them, and they took orders from the office which I represented without having to tell them that.

Q. When you filed your return March 15, 1943, a year and three months after the original partnership, you show on your return as salary \$7,945.01 salary.

A. I don't know. In 1943 I was in the Army and I signed these papers which our counsel had prepared and which our bookkeeper had prepared and, frankly, sir, I didn't go into detail.

Q. Mr. Jacob knew you were a so-called partner, didn't he?

A. As a matter of fact, I don't think Mr. Jacob himself prepared it. I knew that he personally knew it, but his office did not, [216] nor did our bookkeeper. I had personally thought she probably did, but I realized she did not know, and I know that his office did not know it. The bookkeeper prepared the statement, as a matter of fact.

Q. On May 15, 1944, or two years and five months later, you filed an amended return, is that right?

A. That, I believe, is correct.

(Testimony of William A. Hammond.)

Q. That return is subscribed and sworn to before Mr. Jacob, your counsel?

A. Yes. I believe Mr. Jacob advised me that I had made a mistake and that he wanted to correct it.

Q. That was the first time you included any of this alleged partnership income in your return?

A. That was the first time I realized that it had not been previously correct.

Q. As a matter of fact, you know that a percentage of the profit had been charged on the books, that is, yours, Mason's and Petersen's, had been charged to Contract 208? Did you know this to be a fact, that Job 208 was charged with some \$47,000 as overhead expenses or salaries, \$47,254.08, that is, the Troutdale job? Did you know that?

A. I don't know it to be a fact but I would presume it is correct since Mr. Petersen spent his entire time on the job.

Q. Was it your practice to charge the salaries of superintendents such as yourself, Mr. Petersen and Mr. Mason, to the job on which [217] you were working at that time?

A. That was quite the normal practice. When we were directly superintendents, that bore the cost of that job and when we were general, we were spread over several jobs.

Q. On the Guilds Lake job in 1942, \$53,307.66?

A. That is very proper.

Q. It was your practice to so charge the overhead?

(Testimony of William A. Hammond.)

A. Our practice was to charge all costs of supervision to a job, because that is what it was. It cost us that much to complete.

Q. How about Job 211?

A. Which job is that, sir?

Q. University Homes, that housing project, a cost-plus job.

A. That was Mr. Mason's. He was superintending it and he had practically a separate office of his own.

Q. He was general superintendent of that particular job?

A. That particular job was big enough to be a business by itself, sir, for a period of 120 days or so.

Q. Were you in charge of the Guilds Lake job?

A. Yes, Guilds Lake.

Q. During all of 1942?

A. I left in 1942, in October.

Q. Until October? A. Yes.

Q. Who was in charge of the Troutdale Aluminum Plant job?

A. Mr. Petersen was directly the superintendent, and that particular [218] job came under the supervision of the main office, contrary to University Homes which did not. In fact, practically nothing was submitted to the main office on University Homes. We tried to keep it separate. We set up a separate payroll account. Troutdale was under the supervision of A. V. Petersen; 100 per cent of his time was spent there, and then it was

(Testimony of William A. Hammond.)

also under my general care and Ross B. Hammond's general care.

Q. I don't believe you stated, Mr. Hammond, when you were married. You say it was about six years ago. Do you recall when you were married, the date?

A. February 21, 1941.

Q. I take it you were drafted in December, 1941?

A. No, sir, I never was drafted.

Q. Well, you were called in the Reserves?

A. Yes, I had been a Reserve Officer for some time, and I received telegraphic orders to report to Fort Lewis for duty with the Artillery. I was there from the 26th of December, 1941, the first time to the 20th of January, 1942.

Q. Then you returned to Portland at that time?

A. Yes, sir, I was ordered to return to Portland by the 20th. I got back, I think, on the 19th.

Q. Ordered to return to Portland?

A. In the Army they issue orders.

Q. That is, they released you from the service?

A. As a Reserve Officer, you are always in the service. You [219] are just subject to orders to report to active or inactive duty.

Q. Did you expect to later be called to the service?

A. Quite frankly, I didn't know. I didn't really expect to, because I had fought pretty hard to get in and stay in the first time. However, I was ready to go at any time for any type of training

(Testimony of William A. Hammond.)

they might want. I had had nine years' training in military service.

Q. Then you were not called again until October of 1942?

A. I was not called in October, 1942. I asked for a physical, but I think it was October 1st. I stalled the physical for ten days because I had a hunch it would mean I was going in and I wanted time to clear up my matters. Then I took my physical and I was correct—I think three days after I had taken my physical and I had signed another waiver, waiving any rights to collection because of my physical defect, then they gave me three days to get in. I mean, they gave me three days to report to Santa Ana, California, on October 12th.

Q. The only explanation you can make of the reason you did not include your partnership income in your return for 1942 is that somebody else made the return and you did not know about it?

A. I would say that I had every confidence in the world in the people who were making the returns for us. They had been doing it for quite a number of years and, rather than to take a lot of my time to try to figure out that Government stuff, I certainly would expect them to have prepared it correctly. [220]

Q. Did you actually believe you only had an income of \$7,944 in that year when you filed the return and that you only had a tax of \$1,474?

A. As a matter of fact, I probably did not give it much thought. I presumed it to be correct and

(Testimony of William A. Hammond.)

just signed it, and also signed the check that they had ready for me to pay it with.

Q. Do you mean to tell the Court you presumed the return to be correct, when you had actually \$45,000 income—\$44,629, when you read that return, Mr. Hammond?

A. I don't remember reading that return, to tell you the truth.

Q. You knew how much taxes you would have to pay, didn't you?

A. If I had known that it was wrong, I would not have signed it.

Q. You are a college graduate?

A. Yes, I am.

Q. You were twenty-four years old or about twenty-four years old?

A. At that time, yes.

Q. And a graduate engineer? A. Yes.

Q. You were claiming to be a member of this partnership handling millions of dollars in contracts? A. Yes, sir.

Q. Do you mean to tell this Court you did not know you had a tax liability of more than \$1,400 on an income of \$7,945, [221] Mr. Hammond?

A. Mr. Winter, we were handling so many papers and so much money at that time I might not even have known when—known what I was signing, other than to know that it was prepared and given to me by people who should know what they were doing.

Q. You are familiar with the jurat?

A. Yes, I am, sir.

(Testimony of William A. Hammond.)

Q. You declare, under pains of perjury, that the return includes all your income, don't you?

A. Yes.

Q. And yet you tell us that you had been advised you had partnership profits of \$44,000?

A. Yes.

Q. That is the only explanation you can give us?

A. You are putting these figures in my mouth. I presume if they come out of the record they are correct.

Q. Just take a look at your return.

A. This is an amended return.

Q. There is the original return and the amended return. That is your signature, isn't it?

A. Yes, both of them are my signature.

Q. Where were you when you signed it?

A. Well, I will have to see when I signed it, sir. I believe this was in the Army, the first one, March 15, 1943; I would have been at probably Williams Field, Arizona, and the other date is [222] 5/15/44—I believe I was home on leave at that time. I probably flew home because my mother was sick. I don't know which it was, but I was back in Portland for a matter of two days and then back on down to the Army.

Q. These are your returns and your signatures?

A. Yes.

Q. You swore to them as being correct at the time you filed them?

A. Yes, sir.

Q. Do you have any other explanation as to the reason why?

(Testimony of William A. Hammond.)

A. The explanation, sir, is that when they are prepared by adequate help and intelligent help that you need—If there was a mistake, as I understand there was in this case—and Mr. Jacobs corrected it—we did everything in our power to correct the mistake we had made. We have always done that.

Q. You told us, Mr. Hammond, that you were advised constantly of your partnership profits in this matter.

A. But I didn't read every matter of detail included in the income tax returns. It takes our bookkeeper literally months to make them up. I certainly cannot digest them or even understand them unless I spend equivalent time doing it.

Q. When all of your income is from salary or from the partnership, and you have been furnished with the figures, you mean to tell us you cannot understand how they put down that amount of salary or partnership return? [223]

A. I am not meaning to say that at all. I could, but it takes time and, as far as I am concerned, my time is valuable, and we have excellent help to do it.

Q. How did you receive the information? How did you receive the information as to your partnership profits?

A. Those were strictly in discussions with Ross B. Hammond.

Q. Over the telephone?

A. Not necessarily; sometimes over the phone and sometimes when we were visiting.

(Testimony of William A. Hammond.)

Q. Have you any record of the partners ever having submitted any partnership records showing the income to which you were entitled?

A. As a matter of fact, I may or may not have. If I do, it may be in my personal files, but I have never been concerned about it, Mr. Winter.

Q. All your work in construction has been under the direct supervision, control and direction of your father, hasn't it?

A. No, Mr. Winter, that is not correct. We are partners, and, technically, I may tell him we are not going to do something or I may go out and do something, but he is my father and I have a great deal of respect for his opinion and, therefore, we are probably mostly guided by him.

Q. As a matter of fact, as your father testified, when you bid on a contract, he calls in you and Mason and Petersen and the four of you consult?

A. That is right. We consult quite frequently in our business.

Q. Do you, as a matter of fact, however, exercise any more control or jurisdiction on any contract to which you are assigned than Mr. Petersen or Mr. Mason? A. Technically, I do.

Q. Or do you exercise any less control? Did you answer? A. Yes, I do.

Q. Over Mr. Petersen and Mr. Mason?

A. Yes, I do.

Q. Any more than you did before you were a so-called alleged partner? A. Yes.

Q. Give us one example.

(Testimony of William A. Hammond.)

A. The fact that I had sent Mr. Petersen out to get things, the fact that I allowed him to go and get things, does not mean I did not exercise it. I exercised it, but I did not come out and give him an order. I didn't have to. Just exactly as a Lieutenant in the Army, you don't always have to order a Sergeant. You can ask him to do something and he does it and you are exercising your control.

Q. You say you had considerable control because you were your father's son. I think that was your statement. A. I probably did.

Q. You are the only son? Your father has no other children? A. That is right, sir. [225]

Mr. Winter: I think that will be all.

Mr. Bischoff: That will be all, Mr. Hammond.

(Witness excused.) [226]

ROSALIE NOVAK

was thereupon produced as a witness on behalf of the plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. Your name is Rosalie Novak?

A. Yes.

Q. Where do you live, Miss Novak?

A. Portland, Oregon.

Q. How long have you lived here?

A. Since 1946.

Q. Since 1946?

A. Yes. Wait a minute. 1936. I am sorry. 1936.

Q. What is your occupation?

(Testimony of Rosalie Novak.)

A. I am office manager and head bookkeeper and what have you for Ross B. Hammond Company.

Q. When did you enter the employ of Ross B. Hammond Company?

A. The first of February, 1942.

Q. What was your occupation before that?

A. Just immediately preceding, I was doing cashiering work for a clothing manufacturer.

Q. How long had you been doing that?

A. I believe eleven months.

Q. What was your occupation prior to that?

A. I was doing all the bookkeeping and secretarial work for an [227] oil burner manufacturing company.

Q. What company was that?

A. The Duplex Manufacturing Company.

Q. You were in the employ of Robert T. Jacob for a while?

A. I was, from the time I first started working up until the time I went with the Duplex Manufacturing Company.

Q. Do you remember the date when you entered Mr. Jacob's employ?

A. August 3, 1937.

Q. When did you leave his employ?

A. 1940, I believe, May. That would be twenty months before I started with Ross B. Hammond Company.

Q. What training have you had in bookkeeping and accounting?

(Testimony of Rosalie Novak.)

A. I took everything in the business course that I could in high school and I had a secretarial business course in a business college.

Q. Here in Portland?

A. Yes, in Portland.

Q. When you entered the employ of Ross B. Hammond Company, was that in the capacity of head bookkeeper? Were you placed in charge?

A. Yes.

Q. There was nobody over you in that organization?

A. No, not in the way of office help.

Q. From the time you entered the employ of Ross B. Hammond Company, will you state what your major duties were? [228]

A. Well, I supervised everything in general and kept Mr. Hammond's personal books and the company books, I supervised completely, although a part of the time I kept them myself and part of the time there was somebody else doing that.

Q. Did you have authority to sign checks?

A. I had authority to sign payroll checks alone and I had authority to sign all—I was the only one authorized to sign checks with someone else except Mr. Hammond. Mr. Hammond could sign them alone, although I usually always signed them also.

Q. Miss Novak, I show you Plaintiff's Exhibit 3 and ask you if your name appears upon that document?

A. Yes. I acknowledged the signatures.

Q. You were also a Notary Public, at that time?

A. I was a Notary Public, yes.

(Testimony of Rosalie Novak.)

Q. How long after you entered the employ of Ross B. Hammond Company did you take the acknowledgment on that paper?

A. I believe it was the next day. It was just after I came there.

Q. When you acknowledged the signatures on that paper, were you told the contents of that paper? A. No, I was not.

Q. Did you read it to learn what the contents were? A. No.

Mr. Winter: We object to leading questions, if your Honor please. [229]

The Court: Answer the question.

A. No, I didn't read it.

Mr. Bischoff: Q. Were you told by anyone that the document was a partnership agreement?

A. I was not. All I was asked to do was to acknowledge these signatures.

Q. And that is what you did?

A. And that is what I did.

Q. Were you told to make any entries in the books of the company with respect to any partnership arrangement between Ross B. Hammond and his son, William A. Hammond?

A. No, I was not.

Q. At any time during the year 1942 were you aware of the existence of any partnership between Ross B. Hammond and his son, William A. Hammond? A. No, I was not.

Q. When did you first become aware of the existence of a partnership between Mr. Hammond and his son?

(Testimony of Rosalie Novak.)

A. Well, it was either the latter part of 1943 or the early part of 1944, before the 1943 returns were filed, made and filed.

Q. That was in the course of the preparation of the income tax return for the year 1943?

A. At the end of the year and when the returns were being worked up.

Q. How did the information come to you? How did you become aware [230] that there was a partnership in existence at that time?

A. Well, I believe Mr. Hammond and Mr. Jacob were discussing it, and that was when it came to my attention and I was told about it.

Q. Did you prepare the income tax return for Mr. Ross B. Hammond for the year 1942?

A. Yes, sir, I did.

Q. At that time did you know that there was a partnership in existence?

A. At the end of 1942, no.

Q. I show you the income tax return for the year 1942 of Ross B. Hammond, a part of Plaintiff's Exhibit No. 6. Will you please look at it and state who prepared that return?

A. Yes, I did.

Q. Upon what basis did you prepare it?

A. I followed procedures in previous years.

Q. At the time you prepared that return, did you know that there was a partnership in existence?

A. No, I did not.

Mr. Winter: She has both the 1942 returns, the original and amended.

(Testimony of Rosalie Novak.)

A. No, I have just one. There is just one here. 1942, Ross B. Hommand.

Mr. Bischoff: I show you the return for 1943 for Ross B. Hammond and ask you whether you prepared that return? [231]

A. Yes, sir, I did.

Q. Was that submitted to Mr. Jacob for approval?

A. Yes, and he has signed this one.

Q. Was it in the course of the preparation of that return that the partnership was disclosed?

A. The preparation and events leading up to the preparation, yes.

Q. What was said with respect to the 1942 return at that time, and when you were informed of the partnership?

A. Well, it was realized they were made incorrectly and that they should be amended.

Q. Was an amendment made at that time?

A. They were amended and they were filed at the same time as the 1943 returns, and we had gotten an extension, I believe.

Q. At the time of the preparation of the 1943 returns, was the partnership interest of William A. Hammond reflected?

A. When the return was made for 1943, I am sure it was divided on a 75-25 per cent basis.

Q. In connection with the preparation of the 1943 returns, were partnership returns prepared for the years 1942 and 1943? A. Yes.

(Testimony of Rosalie Novak.)

Q. I show you these two returns and ask you if those are the returns prepared for the partnership at that time?

A. Yes, these are the returns.

Q. Did you prepare those? A. Yes. [232]

Q. In those returns did you reflect the respective interests of Ross B. Hammond and William A. Hammond?

A. Yes. Took for Ross B. Hammond, 75, and William A. Hammond, 25 per cent division.

Q. When you came to work at the Ross B. Hammond Company in February, 1942, upon what basis were the accounts kept, as you found them?

A. Do you mean upon the accrual basis? Is that what you mean?

Q. I want to know whether they were kept on a cash or accrual basis?

A. On an accrual basis, both personal and the company, and of course they were all the same.

Q. Did you make any change in the method of keeping accounts after you took charge of the book-keeping? A. No, I didn't.

Q. Were those accounts kept in the same way consistently during the time you were there?

A. Yes, to the best of my knowledge they were kept exactly the same way.

Mr. Bischoff: Your Honor, we have some very bulky exhibits I want to call her attention to. May I just refer to them first here at the table?

Q. Miss Novak, I call your attention to these two large books [233] which have been marked Plaintiff's Exhibits No. 23-A and No. 23-B. I will ask you to state what those two books are.

(Testimony of Rosalie Novak.)

A. Those are the journals of Ross B. Hammond Company.

Q. What period of time do they cover?

A. I am not real sure, but I believe they start with about 1938 and they must run through to about 1944.

Q. Would you please take a look at them so you can state to the Court accurately as to the period of time they cover.

The Court: We will recess now until half-past one.

(Thereupon a recess was taken until 1:30 o'clock p.m.)

Court reconvened at 1:30 o'clock p.m., Wednesday, January 14, 1948.

Direct Examination—(Continued)

By Mr. Bischoff:

Q. Miss Novak, you have examined these two journals, Plaintiff's Exhibits 23-A and 23-B. Can you now tell us the period of time these cover?

A. From through the year 1930 and through the end of 1944.

Q. From 1932-1944, inclusive? A. Yes.

Q. Do those journals contain entries of the operations of the business during that period of time?

A. Yes, they do. They are complete. [234]

Q. Did you, during the period of time you were employed by the firm, make the entries in those

(Testimony of Rosalie Novak.)

journals, or were they made under your direction?

A. They were made under my direction and supervision, although I may have made a number of them myself, a part of them.

Q. I call your attention to this book marked Plaintiff's Exhibit No. 24 and will ask you to state what that book is?

A. This is the trial balance book from 1923, which was not Ross B. Hammond, I don't believe, through the current time, 1947.

Q. Right down to date? A. Yes.

Q. Does it contain the trial balances for the years beginning January 1, 1939, to and including the year 1944? A. Yes, it does.

Mr. Winter: That is Exhibit No. 24, Mr. Bischoff?

Mr. Bischoff: Yes.

A. 24.

Q. Will you state what pages that trial balance include the years beginning January 1, 1939, down to the end of 1944?

A. Well, 1939 begins on page 54 and December, 1944, ends on page 81.

Q. The entries in those trial balances for the period of time that you were in the employ of the Company, are those in your handwriting?

A. No, I don't believe so. [235]

Q. Were they made under your supervision?

A. Under my supervision, yes.

Q. And at your direction?

A. That is right.

(Testimony of Rosalie Novak.)

Q. Where was the information taken for the entries in this trial balance, from what source?

A. From the balances on the ledger.

Q. The trial balance entries, do they reflect merely the amounts of the various accounts as entered at the end of the year, or are the entries made there for shorter periods?

A. It is a monthly trial balance, and then the balance sheet or trial balance at the end of the year.

Q. Are you familiar with what is known as the accrual method of accounting? A. Yes.

Q. Does this trial balance book show what accounts were carried on the books of the company?

A. The headings show all the accounts that we have on the books of the company.

Q. Will you read off, in any one year, the headings of the various accounts that were carried?

A. All of them?

Q. Yes, in any one year.

A. The various bank accounts, the accounts receivable, deposits, petty cash, retained percentages on the various jobs—— [236]

Mr. Winter: Retained percentages on the various contracts?

A. Yes. ——prepaid expense, equipment, automobiles, machinery and equipment, office furniture, accrued payroll, accounts payable, accrued interest, accrued taxes, notes payable, bonuses payable in one year, reserve for depreciation; social security deductions, state industrial accident deductions, capital account, interest, income, miscellaneous income, various overhead expenses.

(Testimony of Rosalie Novak.)

Q. Have you read all the account headings that were carried in the books of the company?

A. I did not read each one separately. I grouped a part of them.

Q. Was the same list of accounts carried in each of the years from 1939 down to and including 1940?

A. Yes.

Q. 1944, I should say? A. Yes.

Q. They may have had to do with a different job or something, but they are substantially the same, the headings were the same? A. Yes.

Mr. Winter: Is there any reason for excluding 1938?

Mr. Bischoff: I am doing the examining and I am seeking certain information, Mr. Winter. If there is additional information, you are welcome to have it. She is here and the books are here.

Q. From the list of accounts that you have read off and as they [237] were maintained on the books, are you able to state whether or not those are the accounts that are usually set up under an accrual system? A. Yes.

Q. During the years that you were employed by the Ross B. Hammond Company, did you supervise the making of income tax returns?

A. I made them mostly myself.

Q. And, then, did you submit them for approval to anyone else in some of the years?

A. Usually, Mr. Jacob's office, in this case, assisted in the computations particularly.

(Testimony of Rosalie Novak.)

Q. But you made up the information from which the amounts were determined?

A. Yes, I made that up.

Q. Were these income tax returns made, prepared and executed in accordance with the books as they were kept? A. Yes, they were.

Q. Was there any departure in any of these years I have mentioned from the books in making those returns? A. No.

Mr. Bischoff: At this time we offer in evidence pages 54 to 81, inclusive, of this Exhibit 24.

(Pages 54 to 81, inclusive, of Trial Balance Book thereupon received in evidence and marked Plaintiff's Exhibit No. 24.) [238]

Q. (By Mr. Bischoff): I now show you Exhibit 25 and ask you to state what this book is?

A. This is the ledger of Ross B. Hammond Company.

Q. I beg your pardon?

A. The ledger of the Ross B. Hammond Company, the general ledger.

Mr. Winter: I couldn't hear the answer.

A. The ledger.

Mr. Winter: Of Ross B. Hammond Company?

A. The general ledger of Ross B. Hammond Company.

Q. (By Mr. Bischoff): What period of time is covered by that ledger?

A. 1938 up to date.

Q. Was that ledger kept by you or under your supervision and control?

A. Kept personally by myself.

(Testimony of Rosalie Novak.)

Q. That is, you made the entries in there along with other people in your office? A. Yes.

Q. Your staff of bookkeepers? A. Yes.

Q. From what records were the entries made in this ledger?

A. From the journal, which is on the desk there.

Q. Is this the ledger from which the entries were made in the trial balance book, part of which has been marked Plaintiff's Exhibit No. 24? [239]

A. That is right.

Q. Were the income tax returns made on the basis of the figures disclosed by this ledger?

A. Yes, they were.

Q. Miss Novak, I show you this bundle of folders that has been marked Plaintiff's Exhibit No. 21, for identification, and ask you to state what this bundle of folders contains?

A. This contains billings or estimates, as it may be, on all the jobs concerned in the years 1941, 1942 and 1943, I believe, starting—Shall I list the jobs?

Q. Are you familiar with the jobs or contracts involved in this tax litigation? A. Yes.

Q. Are those the folders that contain all the billings that were rendered in connection with these jobs?

A. There are only two jobs, I believe,—215 was mentioned but that was on a different basis; there were no estimates whatsoever; in fact, we did not pay the bills on it. It was a cost-plus deal.

Q. You mean that there are two folders there that are included that are not involved in this litigation?

(Testimony of Rosalie Novak.)

A. There are a couple of jobs on which we did not have the bills, and that is No. 215, Northwest Ice, on which they paid all the bills except labor, and we were just reimbursed on the labor. Strictly cost plus a fee. [240]

Q. There were no monthly billings—

A. No monthly billings.

Q. But it does contain bills rendered——

A. On any contract job or jobs on which we had any basis to bill. I believe No. 211 was this University Homes, on which the files are terrifically big. That was also a cost-plus-fee job.

Q. Wherever there are billings, are these duplicates of the ones furnished to the Government agencies when bills were rendered?

A. Yes. These are the duplicates.

Q. By whom were they prepared, the final bills that were rendered to the Government agencies? Who prepared them and got them up?

A. Mr. Petersen, Mr. Mason or William Hammond would have prepared them originally and, then, of course, they were typed up by the general office.

Q. Did you examine them before they went out? Did they pass through your hands?

A. Yes, I saw that they were checked and already to go out.

Q. You checked them before they went out?

A. Yes.

Q. Did you make the book entries on these billings as they went out?

(Testimony of Rosalie Novak.)

A. Either made or supervised the entries, yes.

Q. They were made under your direction, then?

A. That is right.

Q. I hand you Plaintiff's Exhibit No. 35 and ask you to state [241] what that record represents?

A. This represents a breakdown of the capital and drawing accounts between W. A. Hammond and Ross B. Hammond.

Q. In whose handwriting is that record?

A. That is in my handwriting.

Q. When did you make the entries that appear upon that record?

A. Started making them in 1943, I imagine, when we first made the partnership returns, and ever since.

Q. When you learned of the existence of the partnership, you set up that account?

A. Yes.

Q. And you have maintained it, in fact, ever since?

A. Maintained it in what?

Q. You have maintained it from that time on?

A. That is right.

Mr. Winter: Is that Exhibit 35?

Mr. Bischoff: Yes.

Q. Where was this maintained? Of what record is it a part?

A. It was kept in my own files which were—which I had in connection with making the returns and financial statements, and what have you.

Q. A miscellaneous file of your own?

(Testimony of Rosalie Novak.)

A. My own personal returns in support—my own personal files in support of the tax returns, and what have you.

Q. What I am trying to find out is: Was this page a part of [242] any book?

A. No, it was not; just in a folder that I had.

Mr. Bischoff: May it please the Court, I have two or three questions to ask the witness which I wish to ask without waiving our objection that we made to evidence introduced by the defendant with respect to the Mason and Petersen deductions.

We have been taking the position, as your Honor knows, that those are not issues in this case and that they have been disposed of by your Honor's ruling, but the evidence was allowed to go in on that subject, subject to objection.

I don't know at this time whether your Honor will rule that the issue is or is not before the Court and, so, I think it is necessary to introduce some evidence in connection with that, without waiving the objection that I have made or conceding that it is an issue in the case.

Q. Miss Novak, were you aware of the profit-sharing agreement between or with Mason and Petersen? A. Yes, I was.

Q. With Mason and Petersen?

A. Yes, I was.

Q. You know what share of the profits each of them was to receive? A. Yes, sir, I do.

Q. Did you make entries on the books or cause to be made entries on the books of the company

(Testimony of Rosalie Novak.)

reflecting their share of the profits at the end of the years 1942 and 1943? [243]

A. Yes, at the end of all years from 1942 on.

Q. The computation of their shares of the profits, was that made on the same basis that you determined the profit of the firm?

A. Well, those were determined from the profits of the company, without any allowance for Petersen, for salary for Petersen or Mason?

Q. The method of determining the total profit of the business, was that the same method that was employed in determining Petersen's and Mason's share?

A. Yes.

Q. Were their shares of the profits determined before or after deducting State and Federal income taxes?

A. There was no deduction for any State or Federal income taxes.

Q. I show you Exhibits 31 and 32, for identification, and ask you if these are the records on which you made the entries of their shares of the income for the years 1942 and 1943?

A. These are the accounts payable sheets, showing the amounts due them.

Q. Were those entries made by you, made or supervised by you?

A. Yes.

Q. Are any of the entries in your own handwriting?

A. They are.

Q. In your own handwriting?

A. Yes, a few of them are. [244]

Q. Were the shares of the profits determined

(Testimony of Rosalie Novak.)

in those two years for Petersen and Mason paid to them at any time?

A. They received a drawing account and, then, in addition, Mr. Petersen has been paid in full. Is that what you mean?

Q. Yes. I want to find out if all the profits which were credited to them were paid?

A. Mr. Mason has been paid in full.

Mr. Winter: We will object to it, on the ground, your Honor, it is incompetent, irrelevant and immaterial if they have been paid now. The question is whether they were paid in 1942 or 1943, the years here involved.

The Court: Answer.

A. They have been paid in full as of now, as of those dates.

Q. (By Mr. Bischoff): Will you state the dates of payments that were made to Mason?

A. In December, 1942, he received a total—received total actual cash of \$10,000, and December, 1943, he received actual cash of \$10,000, and the rest was set up as an account payable.

Q. Were there subsequent payments made to him?

A. Yes, he received \$10,000 also in 1942; \$12,500 in 1945; and in 1947 he received \$40,000.

Q. Give us the dates of the payments in 1947.

A. January 14, 1947, \$20,000.

Mr. Winter: January what?

A. January 14, 1947, \$20,000; July 15, 1947, \$20,000; January 7, [245] 1948, \$49,758.28.

(Testimony of Rosalie Novak.)

Q. Did that close out his account?

A. He is paid in full, yes.

Q. Is Mr. Mason still associated with the firm?

A. He is no longer with the organization.

Q. When did he leave his employment?

A. December 31, 1946.

Q. Were payments made to Petersen on account of the profit-sharing arrangement?

A. Mr. Petersen received \$7,500 in 1942, 1943 and 1944; for 1945 he received \$12,500; 1946, \$17,500; and in 1947, he got \$35,000.

Q. Give me the date in 1947.

A. December 31st.

Mr. Winter: December 31st?

A. Yes, 1947.

Mr. Bischoff: I offer in evidence Exhibit 31 and 32, subject to the reservation that I made, your Honor, that we did not waive our objection.

Mr. Winter: We would like to ask the witness one or two questions about these exhibits, before they are received.

The Court: Proceed.

Mr. Bischoff: I omitted to ask one more question that should have been asked.

Mr. Winter: Yes.

Q. (By Mr. Bischoff): Miss Novak, do you know whether these payments [246] that you have testified that were made were made in cash to these people?

A. Yes, they were; they were made in cash. They were given checks, and they were deductible within the years specified.

(Testimony of Rosalie Novak.)

Q. (By Mr. Winter): Miss Novak, you are referring to Exhibit 35. Where were those sheets taken from?

A. What is 35?

Q. Those are the sheets you have there?

A. This is 31 and 32. Is that what you mean? 35, I believe, is the sheet that you have there.

Q. May I see the sheets, the exhibit?

A. Yes.

Q. Just tell me where you took these sheets from and in what book they were kept?

A. They were taken out of the accounts payable breakdown ledger.

Q. Is that a running account payable of all accounts payable?

A. The book that that is in, I believe, only contains current overhead. We kept each job separately, the accounts payable on each job separately.

Q. When a job is completed, the record in that book is written into the general ledger or journal?

A. No. This is a breakdown of the accounts payable account in the general ledger.

Q. It is a memorandum account, isn't it?

Mr. Bischoff: Let her finish. [247]

A. Pardon?

Q. (By Mr. Winter): That is a memorandum account book?

A. Well, accounts payable book, breakdown book, and each job is kept separately.

Q. In other words, it is a subsidiary ledger to the general ledger?

A. Well, it would be classified as such.

(Testimony of Rosalie Novak.)

Q. When a contract is completed, the sheets from this book are taken out and destroyed?

A. They are not destroyed. When the accounts are all paid on that particular job, they are filed in with our job account. We keep all our files separately on each job.

Q. Are there any records in that book you took it from prior to 1945?

A. Yes, the overhead section is kept—I mean, if we had an account that we had in 1938 and still have it currently, that is in the overhead section.

Mr. Winter: That is all.

The Court: Admitted.

(Subsidiary ledger account of A. V. Petersen thereupon received in evidence and marked Plaintiff's Exhibit No. 31.)

[Printer's Note]: Plaintiff's Exhibit No. 31 is set out at page 648.

(Subsidiary ledger account of H. M. Mason thereupon received in evidence and marked Plaintiff's Exhibit No. 32.) [248]

[Printer's Note]: Plaintiff's Exhibit No. 32 is set out at page 649.

Mr. Winter: One other question, your Honor.

Q. Was the drawing account of Mr. Mason and Mr. Petersen shown in any other book other than that accounts payable ledger?

A. Drawing account?

Q. Yes.

A. During the year it is put under "Office Salaries" and then, at the end of the year, it is reversed.

(Testimony of Rosalie Novak.)

Q. You mean, reflected in office salaries on each particular job?

A. No, it is under "Overhead," not on each job.

Mr. Bischoff: I wanted to ask another question or two.

Q. Miss Novak, when you made up the bills for the monthly estimates, you of course observed the way they were gotten up and what items were included in them? A. Yes.

Q. Do those billings include the amounts that were due but which might be deducted as retained percentages?

A. The accounts in all cases show the gross billing. That is, it shows the retained, 10 or 15 per cent, whatever it might be, with the net amount that they are to pay right now.

Q. Did you set up in an account also the retained percentages which had been earned in that year?

A. The retained percentage is set up in the retained percentage account and the balance is in the accounts receivable.

Q. The amount of your billing, then, is split up in two parts, so to speak, am I correct? [249]

A. We have a gross amount and then against that is the retained percentage in the current accounts receivable.

Q. Did the gross billing go into the income in each year in your book entries?

(Testimony of Rosalie Novak.)

A. Yes, the gross billing is set up as income to the job, and the others are on the accounts receivable basis, although the retained percentage we cannot get right at the moment.

Mr. Bischoff: That is all.

Cross-Examination

By Mr. Winter:

Q. I think you stated you worked for Mr. Jacob, counsel for the plaintiff here, from August 3, 1937, to May, 1940, is that correct?

A. Approximately that. I don't remember the exact dates.

Q. In the capacity as a bookkeeper?

A. I was the only girl in the office at that time.

Q. Well, did you keep his personal set of books or keep clients' books?

A. I didn't actually keep any separate books for any client, no.

Q. Did you have any work in connection with Mr. Hammond's books during any of that time?

A. Mr. Jacob, I believe, was handling his work at that time and I may have typed up some returns. I don't remember that particularly.

Q. You say you went to work for Mr. Hammond February 1, 1942? [250] A. Yes.

Q. And two days later you took the acknowledgment of Mr. Mason on Plaintiff's Exhibit No. 4 (marked as Defendant's Exhibit No. 4), which is the agreement of employment, is that right?

A. Yes, I did.

Q. And you took the acknowledgment of Mr. Petersen on Exhibit No. 5? A. Yes.

(Testimony of Rosalie Novak.)

Q. His agreement of employment for a percentage of the profits? A. Yes.

Q. You took an acknowledgment of the Articles of Partnership on the same date, is that right?

A. Took acknowledgment of the signatures, yes.

Q. Just of the signatures? I didn't ask you that. I said, you took the acknowledgment, didn't you?

A. Yes, sir, I did.

Q. You took acknowledgment of the power of attorney, which is on one sheet, on the same date?

A. Yes.

Q. And you took the acknowledgment of the bill of sale from Mr. Hammond to his son on the same date? A. Yes.

Q. Were they all present at the time the acknowledgments were taken, Mr. Hammond, his son, Mr. Petersen and Mr. Mason?

A. You mean at the same time? [251]

Q. Yes.

A. Well, Mr. Petersen would have been in my presence, Mr. Mason would have been in my presence and Mr. Hammond—Both the Mr. Hammonds would have been.

Q. I just want you to look at Plaintiff's Exhibit No. 3. Notice the signatures of the parties are in different ink?

A. Yes, so is mine. All three are in different ink and different pens.

Q. All the other exhibits seem to be in the same ink, your signature and all appears to be in the same type of ink?

(Testimony of Rosalie Novak.)

A. I don't know. I would have to look at that.

Q. Just take a look at it?

A. They are all made with a different pen.

Q. The signatures? A. Yes, all three.

Q. All three with a different pen on the same date, by you, is that right?

A. Beg your pardon?

Q. All of your signatures are made with a different pen?

A. They are all with a different pen. They all have a different type of pen.

Q. You mean your signatures?

A. My signature, Mr. Petersen's, and Mr. Hammond's and Mason's.

Q. What about yours? Are all of yours made with the same pen? A. Yes, I believe so. [252]

Q. It would appear so, wouldn't it?

A. Yes.

Q. You will notice the words "Subscribed and sworn to" on Exhibits 4 and 5, the words "Subscribed and sworn to before me, the undersigned, a notary public, this" blank day of blank. It is double-spaced, isn't it? A. Yes.

Q. Except in the partnership agreement, it is single-spaced, isn't it?

A. That is a large one and probably it was done to get it all on one page.

Q. Just look at it and tell us whether or not it was on there at the time it was signed.

A. I would say it was.

(Testimony of Rosalie Novak.)

Q. It would have been impossible to have put it on double-spaced, wouldn't it, unless it had been put on at the time the instrument was drawn?

A. Well, it would have been possible at any time to put it on the same sheet, double-spaced.

Q. You want the Court to understand you knew nothing about these agreements, is that it?

A. That is right.

Q. And the first time you knew anything about this particular agreement (Plaintiff's Exhibit No. 3) was late in December, I think you said, of 1943, or March of 1944, when the 1943 tax [253] returns were due?

A. That is right.

Q. Two years later, is that right?

A. Yes.

Q. That is the first time you knew anything about it?

A. Yes.

Q. And yet you say that you did acknowledge their signatures on the date it bears?

A. Yes.

Q. Just take one further look at that. Will you notice that the agreement is drawn with the top sheet and the bottom sheet appearing to be written on paper different from the second and third sheets. Just hold that up to the light and see the watermarks. Are there any watermarks on the front sheet? Look at the second sheet now.

A. There is a watermark on there.

Q. There is?

A. They are both "Success Bond," the first and second sheets.

Q. Look at the last sheet.

A. That is "Success Bond" also. It is in a different position on the page.

(Testimony of Rosalie Novak.)

Q. Did you have that kind of paper in your office? A. I don't know. I don't remember.

Q. What?

A. I don't know whether we carried it or not.

Q. Did you type the agreement? Did you write up the agreement? A. No, I didn't.

Q. Did you write the Mason or Petersen agreements? A. No.

Q. Did you write the bill of sale? A. No.

Q. You knew there was a bill of sale at that time that was executed, didn't you?

A. Yes, but I wouldn't know what the bill of sale covered.

Q. And you knew there was a power of attorney executed at that time, didn't you?

A. Yes, but we have had several powers of attorney on different deals.

Q. When you computed the profit at the end of 1942, and the 25-per-cent profit which was to be computed for the son, how did you arrive at the basis of computing that profit on the return?

A. Well, the drawings had been—I was advised—Wait a minute. How did I figure 1942?

Q. Yes. How did you figure Mr. Hammond was only entitled to 75 per cent of the profits, on what basis? A. In what year?

Q. In 1942, when you prepared the 1942 return?

A. I think it is just mentioned, that 75, isn't it? I don't believe—Wait a minute.

Q. Yes. [255]

(Testimony of Rosalie Novak.)

A. Mr. Hammond had advised that Bill was on a percentage basis and, since his drawing was the same as Petersen's, I had assumed that his was the same, and I had assumed that it was like this.

Q. In other words, Mr. Hammond then told you Bill was on a percentage basis in 1942, is that right?

A. Yes, I am quite sure.

Q. You did not set up any capital account for Bill, but you set up the percentage on the books, didn't you?

A. Yes, because I had assumed that his was the same as Petersen's.

Q. You acknowledged the agreements all on the **same date**. Was there a percentage-of-profits agreement with Mr. Hammond, I mean with Bill, that was signed on the same date also?

A. Not that I had known of.

Q. Not that you had known of?

A. No, but that was about the same date I came there and——

Mr. Bischoff: Let her finish her answer.

A. Anyway, it was about the same date I came and when you are new on a job, you don't know what things are, particularly, and, as far as I was concerned, I was the notary and I was acknowledging the signatures on this agreement.

Q. How many acknowledgments did you take that day?

A. I couldn't possibly tell you how many acknowledgments I took that day.

(Testimony of Rosalie Novak.)

Q. Then you would not know whether there had been any change in [256] that agreement, whether any pages had been added or subtracted, because you only looked at the signatures on the bottom?

A. As far as I am concerned, when I acknowledge it, I am concerned with the signature.

Q. Do you know how many sheets were in the paper at that time?

A. No, I wouldn't say that I do.

Q. You would not know whether the first sheets were the same sheets that were on there when you took the acknowledgment, would you?

A. No, I couldn't swear.

Q. You would not know it because you do not know what was in the instrument? You did not know, did you?

A. No. Well, if you will refer to the Articles of Partnership——

Q. Yes. A. Well, I don't——

Q. Did Mr. Hammond tell you at that time that Bill was now on a percentage-of-profits arrangement with him?

A. Not at that time. If he did, I would not have been particularly concerned until the end of the year anyway.

Q. But he told you, didn't he? You knew Petersen and Mason were on a percentage-of-profits basis as of that time, right then, didn't you?

A. Well, I wouldn't say that I did right then, no.

Q. When did he tell you that his son was on a

(Testimony of Rosalie Novak.)

percentage-of-profits basis and not a partnership basis? [257]

A. I couldn't answer that. I don't know.

Q. At no time until at least the late fall of 1943 or March, 1944, did you ever set up a capital account or a partnership account for Bill on the books, did you?

A. Well, on the general books there wasn't designated any partnership account.

Q. Just refer to William's drawing account in the books. Will you show it to us, please?

A. The drawing account on the books?

Q. Yes.

A. It does not start until later.

Q. Just show it to us, Miss Novak.

Mr. Bischoff: Let her answer.

A. It does not start until either '45 or '46 but, as was explained, it was to be kept secret from the girls in the office as well as anyone that might have had access to the books. That is the reason that was not set up on the books.

Q. Did you know it was a secret back in 1942?

A. I didn't know there was any secret at all.

Q. How did you know it was supposed to be a secret, if you did not know anything about it?

A. I did not know it in 1942. That is what I am talking about. I said up until 194—I don't know the year, 1945 or whatever it was, there was no partnership drawing account set up on the books for W. A. Hammond. [258]

(Testimony of Rosalie Novak.)

Q. Miss Novak, just show us in the books where the drawing account is or any capital account or any account with Mr. William A. Hammond.

A. There is none for the capital account, and that has been kept on that breakdown on Exhibit 35.

Q. You have a drawing account on the books for Bill Hammond. Will you get it and show it to us, please? A. Shall I come down there?

Q. Yes, if you will, please.

A. The current drawing account is not here. It must be on the back of that sheet. That is the accounts payable sheet there, both of those, Petersen and Mason—it is not in here.

One of the girls got some of the current, definitely current accounts, out, and they must have been on the back of Mr. Hammond's current drawings, unless it is misplaced someplace.

Mr. Winter: I would suggest, Counsel, you let the witness answer. If she cannot find it, she can tell us that they don't have such an account.

A. We do have such an account.

The Court: You can look for it at recess. Come back and finish your testimony. Have you some more questions?

Mr. Winter: Yes, Your Honor.

Q. Showing you what has been marked Exhibit 35, you say that record was kept in accounts payable, is that right? [259] A. No.

Q. Where is that record from?

A. This is a record that I had in my own personal files.

(Testimony of Rosalie Novak.)

Q. It was not a part of the records of the company?

A. The only way it was a part of the records is that it was a breakdown of the capital and drawing accounts between the two partners.

Q. And that was prepared by you in December, 1943, or 1944, when you were informed of the partnership? A. The amended return——

Q. Whose amended return?

A. The partnership amended return; I mean the partnership return for 1942.

Q. The delinquent return for 1943 and the—— the delinquent return for 1942 and the 1943 return?

A. Yes.

Q. Did you file an amended return for Mr. Ross B. Hammond? A. As I remember.

Q. As you remember what?

A. As I remember, we did file an amended return.

Q. What change was made in the amended return, if you remember?

Mr. Bischoff: The returns are all in evidence.

Mr. Winter: No, they are not all in evidence.

Mr. Bischoff: All the returns are here. The 1942 return and the amended return for 1942 and the 1943 returns are all in evidence [260] for Hammond and for the partnership and for Bill Hammond.

Mr. Winter: Q. You say you filed an amended return for Ross B. Hammond for 1942?

A. I don't remember.

(Testimony of Rosalie Novak.)

Q. You don't remember? A. No.

Q. Did you prepare the original return?

A. Yes.

Q. Did you file an amended return or prepare an amended return for Mr. William A. Hammond?

A. Yes.

Q. What would be the reason for filing an amended return for Ross B. Hammond for 1942?

A. Well, there possibly was not one filed. I just don't remember.

Q. Would there be any reason for filing one?

A. Well, I guess not. I couldn't say. I would have to check on it. I couldn't say offhand.

Q. What?

A. I couldn't say offhand. I would have to check, but I believe—

Q. There was deducted from Ross B. Hammond's return for 1942 a percentage of profits which you, in 1944, credited to Mr. William Hammond, isn't that right?

A. Well, I believe that there was, as I said, on the basis of [261] the contract—on the basis of the agreement with Petersen, and I assumed it was on the same basis. I think the return was made, making the allowance.

Q. Where did you get the information to make the return in the first instance allowing a partnership profit to Mr. Hammond in 1942?

Mr. Bischoff: Objected to.

A. It was not a partnership profit.

(Testimony of Rosalie Novak.)

Mr. Bischoff: Object to the question. He was talking about Petersen, and not Ross B. Hammond.

Mr. Winter: You mean to tell us the partnership profit was not deducted from Ross B. Hammond's return, the partnership profit which was allegedly due William A. Hammond?

A. In 1942 we are talking about?

Q. Yes, 1942.

A. I am afraid I don't know exactly what you mean.

Q. What percentage of the profits already made for 1942, according to the books of the company, did you use in preparing his 1942 return?

A. As I remember, I did prepare it on the basis of an individual ownership, which was my assumption, and that is the way it had been done in previous years, and since William Hammond, according to my understanding, which was incorrect, had a drawing on the same basis as Petersen, I was assuming that that was 15 per cent the same as Petersen's which is 15, and that is how that was split. [262]

Q. Just look at the return and tell us—Where is the 1942 return? Just look at that return, which is for the year 1942, Ross B. Hammond's return for 1942, and tell us what part of the partnership income was reported by Ross B. Hammond on his return?

A. I couldn't tell it from looking at the return.

Q. Can you compare it with the books and tell us from the books?

A. Well, it would be on the basis of——

(Testimony of Rosalie Novak.)

Q. In other words, did you report 85 per cent or 75 per cent of the partnership profits?

A. I don't know. I would have to calculate it in order to get the exact percentage.

Q. What was the percentage to Mr. Mason?

A. Mr. Mason got 20 per cent.

Q. And Mr. Petersen got 15 per cent?

A. 15.

Q. What did you understand Mr. William A. Hammond was going to get?

A. Since it was on the same drawing, I assumed that it was 15, the same as Petersen's.

Q. When did you later find out it was 25 per cent?

A. Either late in 1943 or early in 1944, when the 1942 returns were being prepared, and when the amended partnership returns were made, and the split was 75-25.

Q. But you did not prepare any amended return for Ross B. [263] Hammond?

A. I say, I don't remember. I don't believe so, but I don't remember.

Q. As a matter of fact, the books and records—the partnership return will show that Ross B. Hammond reported only 75 per cent of partnership during that year? That is, the way you computed it?

Mr. Bischoff: What are you talking about?

Mr. Winter: Will you state the question to the witness?

A. Will you state the question again?

(Question read.)

(Testimony of Rosalie Novak.)

A. I don't remember whether it was exactly 75 or exactly what it was.

Q. You do not remember very much about this thing, do you?

A. Well, if you had a bunch of figures, well, fired at you, you would not be able to remember it, I don't think.

Q. Did you prepare an amended return for Mr. William A. Hammond? A. Yes.

Q. Did he sign it in your presence?

A. That I don't remember. Is there an acknowledgement required on the return? He may have been in the service and it had to be sent to him. I don't know whether he was here at that exact time or not.

Q. In any event, no capital account was set up on the books of Ross B. Hammond, other than his drawing account? [264]

A. There is a capital account and there is a drawing account.

Q. The capital account, I mean, was not set up until 1944, or late 1943?

A. There has always been a capital account.

Q. For Ross B. Hammond? Excuse me. For William A. Hammond?

A. There has never been a capital account set up, even currently, for William A. Hammond. It is a company capital account and that Exhibit 35 is a breakdown between the portion that is applicable to the two partners.

(Testimony of Rosalie Novak.)

Q. The tax liability was under investigation in the summer of 1944, wasn't it, when the Agent came out there to visit you?

A. I believe it was about August, 1944. I am not sure of the date.

Q. In any event, after you were told that the partnership agreement was entered into, then the pencil notations were made on Exhibit 35, is that right?

A. Exhibit 35 was started after I found out that there was a partnership and that I would have to break down the capital drawing account.

Q. Was that started after the Revenue Agent came out or was it started before?

A. Well, it could have been started before because I would have made it up when we made up the partnership return.

Q. Since 1944 you have added to it, haven't you? A. Yes. [265]

Q. It was in pencil, and you told the Revenue Agent that that was the only record of a drawing account and capital account of William A. Hammond, isn't that right?

A. What is that question?

Q. Didn't you tell the Revenue Agent that was the only record in the books of either a drawing or capital account of William A. Hammond?

A. That was the only record in the books.

Q. And that was in your personal files?

A. The combined capital and drawing account was in the company's books that were handled and could be seen by anyone. That was in my personal

(Testimony of Rosalie Novak.)

files and, as has been brought out before, it was because the partnership was not wanted to be known by some of the parties concerned.

Q. How were the drawings and percentages of the profits set up on the books with respect to Mason and Petersen?

A. What do you mean by how were the drawings set up?

Q. What record is there in the books of the percentage of profits due to Mr. Mason and Mr. Petersen?

A. Well, at the end of the year we computed as to how much was due them and then the amount due them was split up between the various jobs.

Q. In other words, refer to the returns for 1942—Do you have it there?

A. I have the Ross B. Hammond return for 1942. [266]

Q. Will you refer to the return for 1942 and to the schedule attached of the contracts.

A. Yes.

Q. Referring to Contract No. 208, how much of the percentage of profits of William A. Hammond, Mr. Mason and Mr. Petersen were charged to that contract in the year 1942?

A. I couldn't tell from this return. It does not state. It just says "Labor" and then "Materials."

Q. Does your record show what part of it was charged to that contract? A. I think so.

Q. What? A. I think so.

Q. Can you show where that is?

(Testimony of Rosalie Novak.)

A. I will try.

Q. Look at the entry of December 31st in the journal, 1942. Just read these entries. You are reading from the cash journal, Page J-125, is that right?

A. Yes.

Q. Will you just read the entries that you have with respect to Job 208 there?

A. Charged with \$47,254.58.

Q. \$42,000?

A. No, \$47,254.58. Guilds Lake, \$53,307.56.

Q. That is Job No. 210, isn't it? [267]

A. Yes. No. 211, \$39,670.81. Office salaries——

Q. That was \$16,400?

A. \$16,467.51. W. A. Hammond was set up——

Q. It says "A. P."

A. Accounts Payable, overhead section, yes. \$37,129.66 for Hammond, W. A. Hammond; Petersen, \$37,129.56; and Mason, \$49,500.

Mr. Bischoff: December, 1942.

A. December, 1942. Wait a minute. Yes, there is an error in the top of the page. It says "43" but it should be "42."

Mr. Winter: Q. These amounts that you have just read with respect to Contracts 208, 210 and 211 were all deducted or taken as profit——

A. ——to the job.

Q. ——to the job, as reflected in profit shown as to these separate long-term contracts.

A. That is right.

Mr. Winter: If the Court please, I have a type-written copy of the entries shown on page No.

(Testimony of Rosalie Novak.)

J-125. Instead of offering the entire book in evidence, we will offer the typewritten sheet showing the entries to which the witness has just testified.

Mr. Bischoff: I would like to know what the purpose of it is. At present I do not see the materiality. There may be some and if Counsel will state what the purpose of this is and what he claims for it——

The Court: What do you claim for it? [268]

Mr. Winter: If the Court please, it goes to the very issue in this case as to whether or not the plaintiff has overpaid the tax by having taken deductions on his previous return to which he would not be entitled. The burden is on the plaintiff to show that he has overpaid his tax. The whole question is whether the plaintiff has overpaid his tax or not.

The Court: What does this tend to prove?

Mr. Winter: These amounts, the percentages paid to Mr. William A. Hammond, Mr. Mason and Mr. Petersen, were deducted as charged against these particular jobs, and they were not proper accruals.

Mr. Bischoff: On the contrary, they are proper accruals because, at the end of 1942, they recognized the liability to these various people and credited it on the books.

The Court: Do you wish to object?

(Testimony of Rosalie Novak.)

Mr. Bischoff: No, I am not going to object, Your Honor. I did not know what the point was.

The Court: Admitted.

(Transcript of Journal Entry 125 thereupon received in evidence and marked Defendant's Exhibit No. 36.)

[Printer's Note]: Defendant's Exhibit No. 36 is set out at page ~~649~~: 651

Mr. Winter: Q. Referring to the trial balance book, Exhibit 24, does the trial balance book cover also the year 1938 or at the beginning of the operations by Mr. Hammond as an individual?

Mr. Bischoff: Objected to, may it please the Court, as immaterial. [269] None of the transactions in 1938 are involved in the years in question here. Ordinarily, we would not make any objection, except that we are spending a great deal of time. This cross-examination, I think, has now developed into more of a badgering process. 1948 is not involved in any way in this case.

The Court: I won't let the lady be badgered. I think she is doing all right.

Mr. Winter: Q. At what sheet in the book does the trial balance start? A. 1938?

Q. Yes; what page? A. Page 49.

Q. Does the book also include records prior to 1938? A. Yes.

Q. Was the trial balance carried on the same prior to 1938 that it was subsequent to 1938?

(Testimony of Rosalie Novak.)

Mr. Bischoff: Objected to as immaterial.

The Court: Go ahead. We will take a ten-minute recess now.

(Recess.)

Mr. Winter: Q. I think you testified the trial balance records for the year 1938 begin at page 49 and, of course, would go up to the beginning of 1939, which is on page 54.

The Court: What is that all about?

Mr. Winter: I want to show, if Your Honor please, that they carried forward the same accounts in the trial balance that were [270] carried in 1938 at the beginning of the period here. Counsel has gone back to 1939. I think we are entitled to have 1938 in.

The Court: Do you want to go back to '37 or '36? Where is your stopping point?

Mr. Winter: I am only asking whether or not a consistent practice was carried out. This is preliminary to my next question.

The Court: What is your next question?

Mr. Winter: My next question is whether or not the same accounts were carried in 1939 and 1940, 1941 and 1942 that were carried in 1938. I won't go back beyond the period involved in this lawsuit.

The Court: Why go back to 1938? What is the significance of 1938? What significance does 1938 have?

Mr. Winter: Counsel seems to indicate that there is some difference between 1938 and 1939. I don't think there is. I want to find out whether

(Testimony of Rosalie Novak.)

the accounts were handled on the same basis or not. That is the year in which the taxpayer acquired the right to adopt the basis which we are concerned with here. It was the year 1938 when they first adopted that basis and they must follow that basis, and Counsel knows that, because it was the very question that was in issue in Mr. Hammond's own case. There he attempted to change the basis. I am not sure that the case went to the Court of Appeals but at least the Tax [271] Court held that he could not change the basis.

Mr. Bischoff: The very reason we are here in court today is because the Revenue Agent says in his report that we departed from the accrual method of accounting that was employed in 1938 and upon which we made our return in -1938; he says in his report, in so many words, that we reported in 1938 on the percentage basis and from 1939 down to the end of the period involved we reported on the accrual basis and he says that we had no right to do that because we did not get permission to do so subsequent to 1938. Let me read Your Honor his statement. Now, Mr. Winter stands up here and tells Your Honor that there is no difference in the accounting system between 1938 and 1939.

The Court: You can read that later. I want to take up these reports with me this evening. You don't need to read it now. Do you know what the question is, Miss Novak? Ask it again, Mr. Winter.

(Testimony of Rosalie Novak.)

Mr. Winter: Q. You read a few minutes ago, in answer to Counsel's question, the accounts reflected in the trial balance book. Were the same accounts in the trial balance book in 1938?

A. As nearly as I can tell, they are the same accounts.

Q. As nearly as you can tell, they are the same accounts?

A. Accounts receivable, accounts payable, job accounts——

Q. The same system of bookkeeping was adopted in 1938 and continued on through the years, did it not?

A. I was not here in 1938. I couldn't tell you exactly. [272]

Q. From your examination of the records?

A. As far as I can tell, the books were kept the same way.

Q. You say the accounts were kept on an accrual basis?

A. I think so, yes.

Q. You are speaking about the accounts?

A. Well, yes.

Q. Is there any record on the books, in any books, of the supplies on hand, the materials on hand in connection with any contract at the end of a taxable year, the taxable year for which no billings had been made?

A. I do not believe there is an account set up in any year.

Q. There is no inventory, as far as you know? As far as you know, the books reflect no inventory showing amounts of material on hand or work

(Testimony of Rosalie Novak.)

in progress at the end of the year, is that right?

A. It seems like, when we were going through them, there were a couple of accounts that had a very small portion spent and there was no way of arriving at a profit.

Q. Were those contracts completed that year?

A. No. It was just the very beginning of the contract; not over a thousand dollars spent on them; there could be no basis for any profit.

Q. That is the only adjustment made in the books with respect to any inventories of material on hand on any job or any work that might have been done on a contract for which no billing [273] had been made, is that right?

A. As far as I know. If there were materials billed, they would appear in the billings.

Q. Were all of the December billings accrued on the books——

A. Yes.

Q. ——in December?

A. Yes, I believe so, yes.

Q. How about the Milwaukie Housing Project, were all of the billings for December accrued on the books?

A. All that we—all that they would accept.

Q. All that they would accept?

A. All that they would accept and that we could collect for at all as of that date.

Q. Were billings made uniformly at the end of the month, or were they made upon completion of some part of the contract for which you were authorized to make a billing?

(Testimony of Rosalie Novak.)

A. Ordinarily, as we went along, it was billed monthly, if possible. Some of them were strung out two months or three months, if there was no basis of collecting it before that time.

Q. Were all the engineer's estimates as of December 31, 1942, or were they at other times during the month of December, 1942?

A. There would be an engineer's estimate every month, I believe.

Q. Were all of the estimates made right at the close of the year or would they be made maybe twenty or thirty days prior to the end of the year? [274]

Mr. Bischoff: That is objected to. I do not think it is proper cross-examination. There are some limits, even to cross-examination.

Mr. Winter: It is important whether the estimates were made as of the first of December or the 31st. Just a minute. I am addressing the Court. We think it is important to know whether or not the estimates were made as of December 31st or whether estimates were made which might be due on the 1st of January. I mean, the 2nd or 3rd of January of the succeeding year.

The Court: Important in what respect?

Mr. Winter: It is important in respect to whether or not their costs that had been incurred and money expended would be included in some billings that would not be billed until the next year and would, therefore, take into consideration, as

(Testimony of Rosalie Novak.)

provided by the Regulations. As the Regulations provide, consideration must be given to those matters.

The Court: The contracts state when estimates shall be made, and at what time, don't they?

Mr. Winter: I don't think so. I think estimates can be made when they submit a claim to the Government.

The Court: What contract are you talking about now?

Mr. Winter: I am talking, generally, about all the contracts. I do not want to go into each particular contract.

The Court: Just take any one contract. There is a pile of them there. Pick out any one contract and see if there is any [275] clause in it with respect to when estimates are made. You look at it. Don't ask me to read it to find a clause in there.

Mr. Bischoff: There is a bundle of them. The contracts are in that bundle.

The Court: Can we agree whether or not it is a fact each contract provides the time that estimates shall be made?

Mr. Bischoff: Yes.

The Court: What is your view about it?

Mr. Bischoff: They require monthly estimates.

The Court: All right. Let us find the clause. You take a typical contract, you and Mr. Jacob, and find the clause as to that.

She was not examined on this in chief, Mr. Winter. You may make her your own witness. This woman is not a contractor or engineer or su-

(Testimony of Rosalie Novak.)

perintendent. She is a bookkeeper. She testified to nothing about this in chief. If you want to ask her about any contract, you get it and hand it to her and give her a chance to answer.

Mr. Winter: In all due respect to the Court, I was going to ask her about the billings which she identified and testified to. I want to ask her about these estimates. That is what I am trying to find out about.

The Court: Did you ever see any of these contracts, Madam?

A. Yes, I have seen them there in our files in the office.

The Court: Were you familiar with them from time to time? [276] A. To a certain degree.

The Court: Do you know what they provided as to estimates?

A. In most of them, you are entitled to make an estimate on the first of the month and your payment would be received, part of them say, within ten or fifteen or thirty or how many days after that, and it has to be accepted by the owner or the owner's representative or engineer.

The Court: In other words, estimates were made monthly, in most instances? A. Yes.

The Court: Do you know of any rule as to estimates being made at a particular time?

A. As I said before, when it was possible, at the completion of a job, when the amount is not very much, or there is a question where they have already refused them, and it would not do any good to submit another estimate.

(Testimony of Rosalie Novak.)

The Court: The same clause would apply as to any other month in the year. December would be the same as any other month in the year under the contract?

A. Yes, the contract in the case of Contract No. 207, which is the Milwaukie Housing Project, in that case it would not have done any good to bill them for that amount because they would not pay it and did not pay it until late in the next year.

The Court: Why?

A. They would not accept it because the work, according to them, [277] was not suitable, and we did not know how much money we would have to spend in order to put it in suitable shape.

The Court: That was the end of the contract?

A. That was the end of the contract.

The Court: There was a dispute at the end of the contract? A. Yes.

The Court: But I mean as to the usual case; December is no different than any other month?

A. No.

The Court: As far as estimates are concerned?

A. That is right, on any of these contracts where we had any lump-sum amount at all.

The Court: Go on, Mr. Winter.

Mr. Winter: Q. Estimates were not made every month, though, were they?

A. In practically all cases.

Q. Well, in some of the contracts, estimates were not made at all during December, though there had been partial work completed on them?

(Testimony of Rosalie Novak.)

A. As I said, in the Milwaukie Housing Project, I doubt very much if there was any estimate in December.

Q. On your books you made no allowance for any amounts for which estimates had not been given, although a considerable amount of work had been expended on the job?

A. If we could not get the money, that is right.

Q. You made all billings which we have referred to?

A. I did not make the billings myself. I typed or had them typed up, but I did check them.

Q. They were under your supervision for figures only?

A. That is, for addition and computation.

Q. You referred to an exhibit, that bundle of papers, Exhibit 21. You say that exhibit includes all the billings or estimates on all the contracts in progress during the years 1941, 1942, 1943 and 1944, is that right?

A. I didn't say 1944, because 1944 is not in question here, is it?

Q. Well, there were some of the contracts that were started in 1942 that were not completed until 1944, weren't there?

A. Yes, that is true, but not any that started in 1944. Those are not here.

Q. You have none of the billings for 1944?

A. Not on any job that started in 1944.

Q. That is what I mean. A. All right.

Q. Any job that started prior to 1944——

(Testimony of Rosalie Novak.)

A. If it started in 1942 or 1943 and was finished in 1944, they are here, I am sure.

Q. All except a few, I think you said. I think you said there were a few exceptions?

A. That is right. [279]

Q. Now, with respect to the drawing account of Mr. Hammond, I show you what has been marked Exhibit No. 33.

Mr. Bischoff: You asked her to look up certain ledger accounts, and they are produced here. The current portion of the ledger was taken out because it was in current use in the office, and it was expected the ledger would be in use here for a long time, so we sent for them. They are here now.

Q. (Mr. Winter): Your counsel has handed me three sheets. However, they appear to be the drawing account of Mr. Hammond for the period of June, 1946, through August 31, 1947, and the securities, stocks and bonds, account, apparently for 1945. I am not interested.

I am interested in any drawing account or capital account on the books back in 1942 or 1943 or 1944.

A. That is not what you asked me for. You asked me for any drawing account of W. A. Hammond in that ledger. I said it didn't start until about 1945.

Q. That is when it was prepared?

A. That is when we started the account that was finally titled "W. A. Hammond."

Q. That was a year after this investigation?

A. I don't remember the date we started it.

Q. I show you what has been marked for identification as Exhibit No. 33. What account is that,

(Testimony of Rosalie Novak.)

A. This was at that time an accounts payable account and any [280] payments made by Ross B. Hammond personally or Ross B. Hammond Company that were applicable to the expense of William A. Hammond were charged to this account.

Q. From what record did you take these sheets, Exhibit 33? A. From the journal.

Q. From the company journal? A. Yes.

Q. In the books of the company?

A. That is right.

Q. That shows the drawing account of Mr. Hammond, does it?

A. The accounts payable account of Mr. Hammond.

Q. It also shows all the drawings he made as against that account? Does it show any reference prior to 1944 to any partnership profits to which he was entitled?

A. It shows no partnership profits at any time, I don't believe.

Q. At the end of 1943 did you accrue in that account any amounts due Mr. Bill Hammond for his profits under the profit-sharing agreement?

Mr. Bischoff: Are you referring to these account sheets in her hand?

Mr. Winter: Yes.

A. Yes, it was accrued on the same basis as Mr. Petersen.

Q. On the same basis as Mr. Petersen?

A. Yes.

Q. And that \$37,000 is in here as due him. How was that computed? [281] What was that computed from?

(Testimony of Rosalie Novak.)

A. That is the figure you had picked out which you submitted in evidence, typed up from the journal page. I don't know what it was.

Q. Page 126-J?

A. I think it was; could be.

Q. You are familiar with these billings and I am not. Will you show us the December, 1941, billing in the case of the Guilds Lake contract, Contract No. 210?

A. If there is one, I will show it to you.

Q. Would you just resume the stand? Take it up to the stand with you. As I understand it, Miss Novak, you have taken from Exhibit 21, which is a bundle of folders, the billings and estimates on the Guilds Lake construction contract, Contract 210. You have it before you? A. Yes.

Q. Will you give the date of the last billing on that contract in December, 1941?

Mr. Bischoff: Do you want December or do you want the last date?

Mr. Winter: I want the last date in December, 1941, of the billings in that case.

Mr. Bischoff: 1941?

Mr. Winter: 1941. That is right.

Mr. Bischoff: They did not start in 1941. [282]

Mr. Winter: What?

A. There was none in 1941. It had not started in 1941.

Q. Are you sure about that?

A. Yes, positive.

Q. I was in error. It was in 1942 and 1943.

(Testimony of Rosalie Novak.)

A. Apparently November was the last one that there is.

Q. November was the last billing?

A. The next one seems to be combined, December and January.

Q. When was the last billing in 1942?

A. I said November 30th, apparently. The next one seems to be a combined one.

Q. Then, a combined billing was made in January of 1943?

A. Probably made in February to include December and January.

Q. Then no income accrued on your books for the month of December?

A. Apparently not.

Q. Just wait until I finish my question. No income accrued on your books from that contract for the entire month of December 1942?

A. Apparently not. There is no estimate to support it.

Q. But all expenses were accrued for that month? A. All expenses, yes.

Q. Yes, but no income reported?

A. That is right.

Q. When would the income be reported on the January billing, [283] which was for December and January, 1943? Would that all be reported in your 1943 return?

A. Apparently it was. The next estimate was for February, covering December, 1943.

Mr. Winter: That is all.

(Testimony of Rosalie Novak.)

Redirect Examination

By Mr. Bischoff:

Q. Pursuant to Mr. Winter's request that he made before the recess to produce the drawing accounts of Ross B. Hammond and William A. Hammond, have you produced those in court here?

A. Yes.

Q. Are those documents here now, available for use?

A. This is the drawing account as started for W. A. Hammond.

Mr. Winter: I want the record to show that I intended to ask for books and records here involved, and these appear to be for 1945, 1946 and 1947 and are not material. Having asked for them to be produced, I now see no materiality and I do not want them.

Q. (Mr. Bischoff): Miss Novak, you have been asked in your cross-examination about an examination of the accounts made by the Revenue Agent, Mr. W. G. Williams. Do you remember that?

A. Yes.

Q. Is that the gentleman who has been sitting here in the courtroom during the trial of this case, next to Mr. Winter? A. Yes, it is. [284]

Q. He was over in your office, the office of Ross B. Hammond Company, making an examination?

A. Yes.

Q. Did you make available to him all the records that he wanted in connection with his examination? A. Anything that he asked for.

(Testimony of Rosalie Novak.)

Q. Did you withhold anything from him that he wanted or thought that was material or necessary at the time?

A. No, I didn't. He wanted to see the books and he saw the books.

Q. Did you give him all the books he wanted?

A. Yes. If there were any other questions he asked, I gave him the information he wanted.

Mr. Bischoff: That is all.

The Court: This item of income that was not shown for December, 1942, what was the amount of that?

A. I don't remember.

The Court: Mr. Bischoff, I am asking you. It occurred at the end of Mr. Winter's examination.

Mr. Bischoff: I did not hear the question, your Honor. I beg your pardon.

The Court: It occurred just at the end of Mr. Winter's examination. He asked about some income that was not shown; the expenses were accrued but the income was not accrued.

Mr. Bischoff: Yes. [285]

The Court: What was the amount of that? What are we talking about? \$50 or \$50,000?

Q. (Mr. Bischoff): Could you tell from the monthly estimates of the Guilds Lake job how much was involved in the monthly estimate made in February of 1943 which included December, 1942?

The Court: Just approximately.

Q. (Mr. Bischoff): The approximate amount.

A. For the two months together, it seems to me—it looks like about \$67,000 for the two months.

Q. Are you able to state from the papers that

(Testimony of Rosalie Novak.)

you have available before you how much of it represented work done in December?

A. No, I couldn't tell you that. I don't know.

Q. Do you know why in that instance December, 1942, was merged with January, 1943, in one estimate?

A. No, I don't.

The Court: Do you have an explanation of it?

Mr. Bischoff: I do not myself, but Mr. Hammond says he knows the reason.

A. The next billing seems to be from—there is only one left after that which seems to be from February 1st to December 17th, so there may have been quite a question.

Mr. Bischoff: We will put Mr. Hammond on the stand to explain that item.

Mr. Winter: In view of the developments, I am going to ask leave to go through every one of the contract involved here [286] and put that information in the record. We have not attempted to reconcile them because we cannot.

The Court: I want it reduced to dollars and cents. That is all I am asking about.

Mr. Bischoff: That is all.

Recross-Examination

By Mr. Winter:

Q. Do you know whether or not in the other contracts the same situation existed as we have been discussing?

A. Milwaukie was the same situation. That was at the end of the year and we could not collect because of the playgrounds, I believe it was.

(Testimony of Rosalie Novak.)

Q. What about Troutdale where you accrued \$1,036,625 in income and accrued \$20,000 more in expenses? Was it the same situation there?

Mr. Bischoff: That has been examined into a number of times, to my recollection. At this time I don't think he should be permitted to go into it further.

The Court: He has not asked her about it.

A. There may have possibly been some billings that could not have been billed.

Q. (Mr. Winter): There was no adjustment on your books or records covering any of the contracts on those matters, were there?

A. Pardon? [287]

Q. I say, there were no adjustments made on your books, so far as accruals are concerned, covering any of these items or any of the contracts?

A. No adjustments?

Q. That is right; no adjustments for billings that could be made that were not made and that were reflected in the next year's income?

A. I don't remember whether there were adjustments made on the contracts. I presume there were, but possibly there were not.

Q. The November 30th, 1942, billing, do you have it? A. Yes.

Q. Where was that entered in the books? Will you show us where it was entered in the books?

A. I imagine at the end of November.

Q. Will you just check it and let us know?

The Court: Look it up some other time. Let us get along. Let it go until the next recess.

(Testimony of Rosalie Novak.)

Q. (Mr. Winter): What was the date of that billing and the amount of the billing?

A. I didn't check it. I will have to have the book again; I mean, the folder.

Q. What was the amount of the billing? Would you enter it on your books as of the date of the billing or when it was paid?

A. It would have been entered on the date of the billing; that is, for the period covered. If it was covering the 1st of [288] November to the 30th of November, it would be entered in November.

Q. You do not find where it was entered on the books? A. I do not find it now.

Q. Would you get the billings for the Columbia Steel Casting plant, the last billing for the year for Job 213, for the year 1943?

A. You say 1943?

Q. That is right.

Mr. Bischoff: What is the number of that?

Mr. Winter: 213.

A. They were billed separately in that case.

Q. When was the last billing in 1943?

A. December 31st.

Q. How much is the amount of the billing?

A. Well, I will have to add them up. There are several different buildings that were being worked on. There was additional work, apparently.

Q. When were those billings entered on the books? A. December 31st, I suppose.

Q. Can you show us in the books where they are entered on December 31st?

(Testimony of Rosalie Novak.)

A. December 31, 1943, by our credit entry of apparently three hundred and some dollars. There is a credit memo. It was credited to the job. Then there was a credit memo that would have reduced the actual billing, a credit from some previous [289] month.

Q. In other words, the billing was reduced by the amount of the credit? A. Yes.

Q. How much is the amount of the credit?

A. \$837.

Q. How much was the billing?

A. \$381 is the amount set up.

Q. The excess amount, then, was not accrued; therefore, not credited prior to the end of the year?

A. There were credits accrued before the end of the year, but there were also some at the end of the year.

Q. The amount of the credits would not be reflected in the income for the year 1943 and still it represents the income for 1942? A. 1942.

Q. Let us take the Northwest Ice Company, the last billings of the Northwest Ice Company.

A. Northwest Ice Company. There is no billing. That is one of the exceptions because it was cost-plus. They were paying all the bills. We had some labor is all, but they paid all the material bills.

Q. You accrued all the labor?

A. Well, we actually paid the labor.

Q. Yet you did not receive payment until——

A. We did not receive it until the very end of the job.

Q. Which was in the next year? A. Yes.

(Testimony of Rosalie Novak.)

Q. You did not accrue that payment during the year 1943, did you? What would the amount of it be? Do you have any record there?

A. Well, it started at \$5,000 and it ended up \$8,900.

Q. You accrued as income \$15,000 in the next year? A. Oh, no. In what year?

Q. In 1944?

A. The Revenue Agent examined the books in August, 1944, and the entries were not all made at that time. 213, Columbia Steel, 215 and 216 were all completed in the next year, but the Revenue Agent did not technically take the figures as they stood on the books at the time of his report or examination.

Q. You reported in your return for 1944——

A. You have not audited the 1944 return. Those are not in question.

Q. Will you refer to Contract No. 208 and give us the last billing, the Troutdale Aluminum Plant, for the year 1941?

A. \$59,000 was the total amount.

Q. When was that billed?

A. December 31st.

Q. Are you looking at the billing or looking at the books? A. Looking at the ledger. [291]

Q. Will you look at the ledger?

A. There isn't a single—there is not just one bill; there are several bills.

Q. Will you look at those bills, please?

Mr. Bischoff: May it please the Court, when Mr. Winter began this line of cross-examination, I did

(Testimony of Rosalie Novak.)

not anticipate the extent to which he would go in conducting it, but I think it is time to call the attention of the Court to the fact that the Revenue Agent's report here has raised no issue about any of our billings. He has accepted all of the income accrued in those various years and predicated his computations upon that information.

When your Honor gets this report and has had time to digest it, you will see that there is no question raised as to any figures involved but, on the contrary, he uses these figures to make his computation.

The only issue that he raises is that he says we should adopt an altogether different basis, a percentage-of-completion instead of the accrual basis.

Now, by this cross-examination he is attempting to challenge the accuracy of these accruals in different years and, it seems to me, he is engaged in an examination that is fruitless for any purpose here. We have no inclination to withhold any information nor to bar any examination, but I think it ought to be within the limits of any issues tendered here. [292]

Mr. Winter: The sole issue in this case, your Honor, is whether or not this taxpayer made proper accruals of income and reported the proper income in this case. That is the whole basis of the Examiner's determination. The accounts are kept on an accrual system but they do not take into consideration the other items which necessarily must be considered, such as this \$59,000 which is reflected

(Testimony of Rosalie Novak.)

in the next year's income. That is the whole issue in the case.

The Court: Gentlemen, from now on you will be required to agree on a pre-trial order before I try a case for you gentlemen again.

Mr. Winter: This case involves about \$175,000.

The Court: I don't care if it involves \$1,175,000. From now on you will be required, before you try a case before me, a tax case before me, to set out in a pre-trial order what the issues are. I don't know what they are.

I heard Mr. Bischoff say, in passing, in his opening remarks, something about some possible errors in the accrual system. His point was that, even though there were errors, that did not vitiate the fact that that was the system in use. As near as I can understand, what you are jangling about now is that you claim the errors are of such magnitude that that does vitiate the system.

Mr. Winter: Yes.

The Court: Since you have not set up your issues, as I [293] shall hereafter require you to do, we will go on and make the best we can of it. Continue with your questions.

Q. (Mr. Winter): Do you have the last billings for 1941 for the Troutdale Aluminum Plant, Job 208? A. These are the billings.

Q. You have them with you? A. Yes.

Q. Would you read off the amount, the dates of the billings and the amounts?

A. December 29th, \$15,676.30; December 31st, \$17,928.94.

(Testimony of Rosalie Novak.)

Q. The next one?

A. December 31st, \$16,783.51; \$323.64.

Q. Where were those amounts accrued on the books? A. Where?

Q. Yes.

A. They were accrued on December 31st.

Q. In what book? A. In the journal.

Q. At page what? A. Journal 1096.

Q. 1096? A. Yes.

Q. Would you just read the entry from the journal so we won't have to have the page marked.

A. Page 1096? [294]

Q. Yes.

A. Each one of these is entered separately and the total is listed in the ledger.

Q. The total is how much?

A. \$59,775.31 was the total accrued to the Troutdale account.

Q. That is the total amount which you reported as income during the year? A. Yes.

Q. Now, go to December of 1942. Before we go there—Well, all right. A. Total \$8,945.30.

Q. What was the date of the last billing?

A. December 31st.

Q. Would you get the billing?

A. There are several billings for that date.

Q. Several billings on the same date?

A. Well, yes, there were. This was not billed.

Q. Those billings were not made at the end of the month? They were made at different times in the month?

A. I guess they were at the end of the month.

(Testimony of Rosalie Novak.)

Q. What are the dates of the billings?

A. Some on the 3rd, some on the 18th.

Q. The 3rd of December, 1941?

A. 1942; and there were some made January 1, 1943. I am not sure offhand where they went. That is apparently for December. [295]

Q. What do you mean by "this"?

A. December 3, December 18 and January 6.

Q. They all went into December of 1942?

A. Yes.

Q. Those billed in January, 1943, went into December, 1942? A. Yes.

Q. What are the amounts that were billed in January that were accrued in 1942?

A. Well, they are relatively small.

Q. Was it the purpose to accrue some billings right after the close of the year back into 1942?

A. They were not made up until January. They were dated in January but they were covering, apparently, December work.

Mr. Bischoff: Talk louder.

A. I said: They were made up just after the first of January and dated in January but they covered December work.

Q. (Mr. Winter): These billings covered different component parts of the contracts?

A. Separate billings. In fact, I think each one of these billings was on a separate bill date. There were, I don't know how many, buildings on the whole job.

Q. If the billing was accrued on December 3, 1942, there might not be a billing on that particular

(Testimony of Rosalie Novak.)

job until January of the next year, nearly two months?

A. In this case it was dated January 6th and another billing [296] was dated February 4th.

Q. As each component part was completed?

A. And as each component part was billable, then it was billed.

Q. Any adjustments made on the books as of December 31st with respect to work which had been completed but for which no billings had been made? A. No, just the billings.

Mr. Winter: If the Court please, I think that is all except I want to examine her about Guilds Lake if she can find the billings on Guilds Lake.

The Court: You look that up and come back for redirect.

Mr. Winter: In connection with the testimony of this witness, we will now offer Pages 49 to Page 54 of the trial balance book, which is in evidence as Exhibit No. 24.

Mr. Bischoff: What is No. 24?

Mr. Winter: That is the trial balance book.

Mr. Bischoff: What are the pages, again?

Mr. Winter: The pages with respect to——

Mr. Bischoff: ——1938?

Mr. Winter: 1938, Pages 49 to 54.

Mr. Bischoff: Object to those, your Honor, as immaterial. Those years or that year, rather, is not involved.

(Testimony of Rosalie Novak.)

The Court: Admitted, subject to the objection.

(Pages 49 to 54, inclusive, of trial balance book thereupon marked as a part of Exhibit No. 24.) [297]

Mr. Bischoff: Is that all?

Mr. Winter: Except for the billings on Guilds Lake.

Mr. Bischoff: Didn't she have those out for you?

Mr. Winter: No. You could not find where it was entered in the books?

A. You said billings?

Mr. Winter: I want the dates when those billings are entered on the books and the amounts.

A. Incidentally, that \$57,000 must have been an error—that is \$67,000.

Q. Tell us the date of the billing and the date entered on the books and the amount. Give us the date of the billing and the amount, first.

A. December 3, 1942, seems to be the billing.

Q. The amount of the billing?

A. The total of the billing is \$126,415.85, less retained percentage. \$126,415.85 was set up.

Q. That was set up on the books as of what date? A. It is here as November 30th.

Q. The billing is dated November 3?

A. December 3.

Q. But it is set up on your books as November 3? A. That is right.

Q. Journal Page 113? 112 or 113?

A. No, 113. [298]

Q. Now, give us the date of the January billing?

(Testimony of Rosalie Novak.)

Mr. Bischoff: January, 1944.

A. February 13, 1943. I read this one incorrectly.

Q. (Mr. Winter): May I see the billing?

A. They must have not paid the month before and that is the reason, \$14,039.15, but I don't see the retained percentage that was collected on this here.

Q. The amount of the voucher is \$67,715.24.

A. That includes \$52,000 of retained percentages which had already been entered as income in the previous year, so for the month of January—\$14,839.15. This other was in error.

Q. Did you accrue the retained percentage on \$67,000 in 1942 then before?

A. That was accrued in 1942, yes. That is always set up as accrued to the job. It is not an account in accounts receivable because it is not due until the completion of the job, but we figure it as income.

Q. Will you point out to me, Miss Novak, where the retained percentage is shown?

A. The retained percentage is not actually shown. The retained percentage represents about five per cent, whereas, in the month before, it was \$107,000—We billed them for \$54,000 each month, December and January, and the next month it was \$19,000 in February—Well, it was not \$19,000 because there was a credit against it later. [299]

Q. What amount do you show as accrued in 1943? Is that the difference between \$54,000 and \$67,718.24?

(Testimony of Rosalie Novak.)

A. Well, in January, \$14,839.15, and we have the same thing the next month.

Q. That exhibit which you handed me shows that the building was not 98-7/10ths completed?

A. That does not mean——

Q. I say, that is what it shows, does it not?

A. That is what it does show because of the amount completed.

Q. In other words, that is the engineer's estimate as to the percentage of completion, the composite percentage of completion of the job?

A. Yes.

Q. It is shown on that exhibit?

A. It says "Percentage Complete." However, that does not mean the actual percentage complete. That is just the actual money.

Mr. Winter: That is all.

Mr. Bischoff: That is all.

(Witness excused.) [300]

ROSS B. HAMMOND

plaintiff herein, having been previously duly sworn, was recalled as a witness on his own behalf and was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. Mr. Hammond, in connection with the Guilds Lake job, Contract 210, it appears that no billing was made for the month of December, 1942, but that a composite or joint billing was made for the month of December, 1942, and the month of Jan-

(Testimony of Ross B. Hammond.)

uary, 1943. Can you explain why that was done in that instance, or the reason for there being no billing in December?

A. It was a very similar case to the Milwaukie Housing Project. As far as we were concerned, we assumed that we were through or practically so, but there developed quite an argument about how we had completed any of the houses on the interior and also whether they were going to accept the sewer system, which was quite a big item, and they refused to recognize the completion on time to permit of billing that amount of work. What those figures were I don't remember at all, but it was a considerable amount because of the large amount of heavy construction, and they did not accept the sewers until, I think—it seems to me it was February, and I think it was considerably later than that when they accepted all the rest, because we argued about it over quite a considerable period of time, and, of course, there was no way of billing it because we could not bill it until we [301] produced the architect's certificate.

Q. They would not issue a certificate in December?

A. Oh, would not issue a certificate at least for any amount that we felt that we were entitled to.

Q. You did not agree upon it and so——

A. We did agree upon it and so he did not pay us.

Mr. Bischoff: That is all.

Mr. Winter: That is all.

(Witness excused.) [302]

A. V. PETERSEN

was thereupon produced as a witness on behalf of the plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. What is your full name?

A. A. V. Petersen.

Q. Where do you live, Mr. Petersen?

A. 625 Southeast 52nd.

Q. Would you please talk louder? A. Yes.

Q. How old are you? A. Thirty-seven.

Q. What is your occupation?

A. General superintendent for Ross B. Hammond Company.

Q. Construction superintendent? A. Yes.

Q. How long have you been in the employ of the Ross B. Hammond Company?

A. About fifteen years.

Q. Continually? A. Yes, sir.

Q. In February, 1942, did you know whether any partnership agreement was entered into between Ross B. Hammond and his son Bill? [303]

A. No, I didn't.

Q. You were not told anything about that in the year 1942? A. No, I was not.

Q. Or 1943?

A. I don't think it was in 1943.

Q. When did you first learn about the existence of a partnership between Mr. Hammond and his son?

A. I believe it was approximately two years or so after—Well, it was about 1944 some time.

United States
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for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
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Transcript of Record

In Two Volumes

VOLUME II.

(Pages 337 to 662, inclusive)

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for the District of Oregon

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(Testimony of A. V. Petersen.)

Q. From whom did you learn of the existence of the partnership? A. Mr. Hammond.

Q. And in what connection did he tell you or inform you of the existence of the partnership? How did it come about that he made the disclosure to you?

A. Well, it was during a general discussion that we had in his office. He mentioned the fact that he and Bill had formed a partnership in the company.

Q. Were you surprised at that information?

A. Not particularly, no.

Q. Did you say anything to him about that when you learned that he had formed a partnership?

A. Well, no more than just the general details on it or general information.

Q. Did he tell you when the partnership was formed? A. Not particularly, no. [304]

Q. Did he tell you why the information had been withheld from you?

Mr. Winter: Objected to as hearsay.

The Court: Answer the question.

(Question read.)

A. Generally, he just mentioned the fact that he wished it to be a secret, particularly from one of our former associates.

Q. Who? A. Mr. Mason.

Q. Do you remember entering into a contract yourself with Mr. Hammond regarding your employment? A. Yes.

Q. In February, 1942? A. Yes, sir.

Q. Had there been any discussion about a partnership for you?

(Testimony of A. V. Petersen.)

A. A partnership for me?

Q. Yes. Had you been asked for a partnership interest in the business prior to that date?

A. Well, no, not a partnership interest.

Q. In the course of your work, Mr. Petersen, particularly in the years 1941 to 1944, did you have anything to do with the matter of making up estimates upon which bills for payment were to be rendered? A. Yes, sir, I did.

Q. State what your work was in that connection? [305]

A. Well, preparing the amount of work completed during the month for invoicing purposes. In other words, we were on the job and would figure the amount of concrete that had been poured during the month.

The Court: You have covered that with two witnesses, now. It is cumulative.

Mr. Bischoff: If your Honor thinks it is cumulative, I will not pursue it.

The Court: No.

Mr. Bischoff: I want to ask one question in that connection with your Honor's permission.

Q. In accumulating your information that was to be included in the estimates upon which the bills were to be rendered, did you include materials that had been delivered to the job?

A. Yes. If any large material items would be stored on the job, they would naturally be included.

(Testimony of A. V. Petersen.)

Q. Did you ever have any, what you might call, inventory of materials on hand; that is, in stock piles, not for immediate use?

A. On each job?

Q. On any job.

A. Some of them, yes, we would; some of them we would not.

Q. At any rate, whatever materials you did bring on the job were included in your billings?

A. Yes. [306]

Mr. Winter: He didn't say that. He said they had a lot of materials on the job.

The Court: You may ask him that on cross-examination.

Q. (Mr. Bischoff): Before the final estimate was made up, did you go over the items with the engineers and architects who were required to approve them? A. Yes.

Q. Did they approve those bills as you prepared them?

A. Yes. They were checked before they were sent in to the office.

Mr. Bischoff: That is all.

Cross-Examination

By Mr. Winter:

Q. Did your estimates always include, up to December 31st, all stock piles on hand? In other words, if you were preparing an estimate as of December 1st, your estimate would not, of course, include any stock pile of materials on hand up to December 31st, would it?

(Testimony of A. V. Petersen.)

A. If there was a surplus of material on hand as of the end of any month it would be included in the estimate for that particular month.

Q. The estimates were not made on all jobs at the end of each month. They were made at different times during the month, whenever the work was completed?

A. Not generally, no; they were generally made at the end of the [307] month.

Q. On any of your contracts, could you bill for all materials on hand or could you only bill for the portion of the building that was completed?

A. I don't believe I understand.

Q. I will put it this way: In all of your contracts, could you bill for materials on hand?

A. If you had material stored on the job, you could bill.

Q. On all contracts?

A. If that was stipulated, yes.

Q. If that was not stipulated, then, of course, you did include the materials on hand, did you?

A. No, we would not.

Q. When could you bill for the portion of a building that was under construction which had not been completed to such a stage that it could be estimated as to the percentage of completion?

A. I don't think I understand that question.

Q. In other words, suppose you were building a smokestack and it was half up. Could you bill for that? On your estimate, could you bill for the smokestack before it was completed, or would you wait until you completed a unit?

(Testimony of A. V. Petersen.)

A. No, if it was half finished we would probably bill for half of it. It depends on the type of job you are doing.

Q. It made a difference what type of contract you were working on, and the state in which the construction was at the time of [308] the billing?

A. Yes.

Q. In other words, you would have considerably more money invested in cost of construction—not considerably more, but you would have almost as much in cost of construction as you would have in the amounts of billings? A. I don't know.

Q. What?

A. I don't know, on that one.

Q. Well, if you had to take out a lot of materials and a lot of equipment in construction, that would cost you money, wouldn't it?

A. Well, it all depends.

Q. Did the estimates that you made involve the percentage of the completion of the building or were they based on the amount invested in the building?

A. Well, which estimates are you referring to?

Q. The estimates that you made.

A. They were made two different ways. One job was on a yardage basis and another job would be on the portion of the work completed.

Q. The percentage of completion?

A. Not particularly. One job would be on the concrete yardage on that particular building for that month; on another job it would be the percentage of the work that had been completed

(Testimony of A. V. Petersen.)

to [309] date. In other words, if you had 25 per cent done, you would bill accordingly.

Q. In answer to Counsel's question, you say with respect to this so-called partnership—Did you understand in February, 1942, that Mr. Bill Hammond was a partner? A. No, I didn't.

Q. You didn't know? A. No.

Q. Did you understand that he was working the same as you were, on a percentage of the profits?

A. I knew he had a contract similar to mine.

Q. A contract similar to yours? A. Yes.

Q. Did he exercise control as a partner in the business? A. Equal control.

Q. Equal control in the business with his father?

A. Well, I wouldn't say it was very equal, but it was in a partnership way, if that is what you mean.

Q. Did he exercise any more control over the business than you did?

A. I wouldn't say more, no.

Q. Did he exercise any more control or voice in the business than Mr. Mason did?

A. As far as jobs, probably not; possibly in the office, yes.

Q. Possibly in the office? [310]

A. Yes, but I don't know about that.

Q. In other words, there was no difference in his right of control over you prior to February 3, 1942, than there was subsequent to 1942, was there?

A. Well, prior to that time I was employed directly by Mr. Hammond.

(Testimony of A. V. Petersen.)

Q. After that time, whom were you employed by?

A. Working directly with Mr. Hammond. It wasn't in connection with Bill Hammond at all, then.

Q. That was after February, 1942?

A. Correct.

Q. Counsel asked you whether or not you asked Mr. Hammond to take you in partnership, and I think you said you were not asking that, but for a percentage-of-profits arrangement?

A. That is correct.

Q. Did you ever ask to be made a partner in the business? A. No, I have not.

Q. Do you know whether Mason ever asked to be a partner in the business?

A. Not in my presence. I don't know.

Q. All you wanted was a percentage of profits?

A. I wanted a share of the profits, yes, on some sort of a basis, percentage basis.

Q. Would it have made any difference to you if Mr. Bill Hammond had been a partner in the business? [311] A. Not at all.

Q. Did you ever discuss it with Mr. Mason?

A. Well, possibly.

Q. Was Mr. Bill Hammond present when you signed your agreement?

A. No, not when I signed my agreement with Mr. Hammond, no.

Q. Who was present?

A. Mr. Hammond and Mr. Mason and Miss Novak.

(Testimony of A. V. Petersen.)

Q. Where were you when you entered into that agreement, in the office downtown, or in Mr. Jacob's office, or where?

A. In our office in the Spalding Building.

Q. Where?

A. Our office in the Spalding Building.

Q. The first time that you heard of the so-called partnership arrangement or agreement was about 1944, wasn't it?

A. That is correct, about that.

Q. When the returns were being made in March of that year?

A. I can't answer that exactly. It was approximately two years later.

Q. Was Mr. Mason with you when Mr. Hammond told you that he had such an agreement?

A. No.

Q. Have you ever seen the agreement to this date?

A. No, I have not asked for it.

Q. Are you still working for Mr. Hammond?

A. Yes. [312]

Mr. Winter: That is all.

Mr. Bischoff: That is all.

(Witness excused.) [313]

GARTHE BROWN

was thereupon produced as a witness on behalf of the plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. Where do you live, Mr. Brown?

(Testimony of Garthe Brown.)

A. Portland, Oregon.

Q. How long have you lived here?

A. All my life.

Q. How old are you? A. Thirty-three.

Q. What is your profession?

A. Attorney and accounting practice, specializing in income tax work.

Q. How long have you been an accountant?

A. About eight years.

Q. You are not a Certified Public Accountant?

A. No, I am not.

Q. Will you tell the Court what experience you have had in accounting?

A. Well, the first training I took, of course, was in high school; then in the LaSalle Extension University. I took their complete course in higher accountancy and took the course of Northwestern School of Commerce here in Portland and extension courses at the University of Oregon. [314]

Q. Where have you practiced your profession after your training?

A. Well, I was employed in accounting work for Adren Farms here, or the Sunfreeze Ice Cream Company; I was there about six months.

Then I was with Montgomery Ward, doing buying and also there was accounting work connected with it. From there I became associated with Mr. Jacob in the preparation of tax returns, and we also, of course, have some clients' books that are kept under our supervision.

Q. Mr. Robert T. Jacob? A. Yes.

(Testimony of Garthe Brown.)

Q. One of the attorneys for plaintiff in this case? A. That is correct.

Q. Are you associated with him in business at this time?

A. Yes, I am a partner with him now.

Q. When was that partnership performed?

A. January 1, 1947.

Q. Does this partnership include any interest in any compensation to be received from this case?

A. None whatsoever. Mr. Jacob had this case prior to that time and it was held out of the partnership, and Mr. Jacob and I both so understand it.

Q. In the course of your employment, prior to the partnership, you worked for Mr. Jacob as an employee? A. Yes.

Q. In the course of your employment by Mr. Jacob, did you have [315] occasion to examine the books and records of Ross B. Hammond Company?

A. Yes, I did.

Q. Over what period of time did you have occasion to examine those books?

A. During the month of November, 1946, both Mr. Johnson of our office and myself spent considerable time in preparation for this case.

Q. Did you have anything to do with Ross B. Hammond's books or accounting methods prior to that time?

A. Well, at various times since I became associated with Mr. Jacob he would bring certain records into the office and ask me to prepare balance sheets. I took over the tax returns for one or two

(Testimony of Garthe Brown.)

different years and was familiar ever since I have been with Mr. Jacob with their records.

Q. But the first time you made any extensive examination of the records of the Ross B. Hammond Company was after this controversy arose?

A. That is correct.

Q. When I say "controversy" I mean after the Commissioner of Internal Revenue had made a deficiency assessment?

A. That is correct, yes.

Q. To what extent did you examine the records in that connection?

A. With three of us working on the job there we checked, first, to see how the billings were made and followed them through the [316] journal to the general ledger. I checked with both Mr. Hammond and Mr. Petersen to see if certain items were not billed and why they were not and determined whether or not items had been accrued; checked the expenses to see that they were properly supported by vouchers, and the three of us made quite an extensive survey of the records.

Q. Tell particularly what you did yourself. Did you, yourself, make this extensive examination of the books?

A. Yes, I personally compared the records with the tax returns in order to see that the items as reported on the tax returns reflected the books.

Q. When you started on that investigation——

Mr. Winter: We will object to this line of testimony, your Honor, on the ground that the witness is not qualified. The witness is a member of the

(Testimony of Garthe Brown.)

partnership representing the plaintiff. He is not called to testify as an expert in this case. His testimony is biased and prejudiced and, if I may bring it out on my own examination, I can show it. I object to this witness testifying. He did not keep the records. He merely investigated them. It is hearsay, as far as he is concerned.

The Court: The objection is overruled.

Q. (Mr. Bischoff): Mr. Brown, when you launched upon that investigation, did you have before you the Revenue Agent's report upon which the deficiency was assessed? A. Yes. [317]

Q. I call your attention to Exhibit 20 and ask you if you had that report before you when you were making your examination? A. Yes.

Q. Did you familiarize yourself with it to be aware of the contentions that were being advanced by the Commissioner? A. Yes.

Q. And upon which the deficiency was prepared? A. Yes, I did.

Q. Did you particularly direct your attention, in making your examination of this problem—First, did you particularly direct your attention, in your examination, to the issues being raised by that report? A. We did, yes.

Q. You recall from that Revenue Agent's report, one of the questions raised is as to whether an accrual method of accounting was used by the plaintiff in the tax years 1939 through 1940.

Did you examine the records that were maintained by Mr. Hammond with a view to determining that question? A. I did.

(Testimony of Garthe Brown.)

Q. And at that time did you examine the books that are now in court, the journal, the ledger, the trial balance, the auxiliary ledgers and billings that have been produced here in court?

A. I know that we had the general ledger, the journal, and we had the contracts before us, but I don't believe we had the [318] trial balance book at that time, but I do know that these three were before us while we were working.

Q. Did you see the trial balance book at any time thereafter?

A. I don't believe I looked at the trial balance book. I think we had our own trial balance that we made up from the books.

Q. From the examination of the records that you have made, are you able to state whether the accounts of the Ross B. Hammond Company were maintained on the accrual basis during the years 1939 to 1944?

A. I am and I——

Mr. Winter: Just a minute. Just answer the question.

Q. (Mr. Bischoff): I just want to know, first, if you are able to so state?

A. I am, yes.

Q. Will you state whether, in your opinion, the books were maintained on the accrual basis during those years?

Mr. Winter: That is objected to, your Honor, on the ground the witness did not keep the books. He has not been qualified as an expert to testify upon what basis they were kept, they were not under his control and in his custody, and he has said

(Testimony of Garthe Brown.)

he did not see them until after the investigation was commenced in this case.

The Court: Objection overruled.

A. The books were kept on the accrual basis.

Q. (Mr. Bischoff): Are you able to state from the examination [319] that you made whether the method of accounting that was used was consistent from 1939 to 1944?

A. They were kept on a consistent basis, yes.

Q. Did you compare the tax returns that were made by Ross B. Hammond Company during the years that I mentioned with the books?

Mr. Winter: During what years, Mr. Bischoff?

Mr. Bischoff: During the years 1939 to 1944, the years I have been talking about.

Mr. Winter: You introduced the returns for 1938 to 1944. I just wondered why you included 1938.

A. I know I checked the years 1940, 1942 and 1943. I am not sure—we had four. 1939. I am not sure about 1939. I do know we had 1942 to 1943, for sure.

Mr. Bischoff: 1941?

A. 1940, 1941, 1942 and 1943.

Q. Those are the returns you examined?

A. Those are the returns that we had and checked.

Q. Did you examine those returns and check for the purpose of determining whether the returns were made on the same basis the books were maintained? A. I did.

(Testimony of Garthe Brown.)

Mr. Winter: Objected to, your Honor. Object to this line of testimony.

The Court: It is so understood.

Mr. Winter: I beg your pardon? [320]

The Court: It is so understood.

A. We did. Checked them, compared the books with the returns for those years.

Q. (Mr. Bischoff): Were the returns made in accordance with the books as they were kept?

A. They were.

Q. From your examination of the books, as they were maintained and kept during the years 1941 to 1944, inclusive, are you able to state whether the books clearly reflect the income?

A. They do, with minor variations, as is true of practically every set of books I examine.

Q. Were you able to tell from the records that you examined whether they accrued items only at the end of the year or whether they accrued items as they went along?

A. They accrued them as they went along over the year.

Q. When? What period?

A. At the end of each month.

Mr. Bischoff: You may cross-examine.

Cross-Examination

By Mr. Winter:

Q. You are a member of the firm of Jacob, Jones & Brown, Attorneys at Law?

A. Correct.

Q. Mr. Jacob is of counsel on behalf of plaintiff in this case? A. Yes. [321]

(Testimony of Garthe Brown.)

Q. As a matter of fact, in November and December, 1946, you had conference with myself, as Attorney for the Government, and the Revenue Agent, as counsel representing the plaintiff in this case, didn't you? A. That is correct.

Q. You are one of the attorneys for the plaintiff in this case, although you won't share in the fee, isn't that right? A. That is right.

Q. You have been working for Mr. Jacob for a number of years? A. That is correct.

Q. You never went out to examine these books until after the Revenue Agent had made his report and you were furnished with a copy of it?

A. That is correct. I looked at the books only after the Revenue Agent made his report.

Q. Counsel is talking about an assessment by the Commissioner. As a matter of fact, the taxpayer signed Form 870 which consented to the assessment without the necessity of a formal letter, isn't that right?

A. That was correct, with the idea of expediting——

Q. No deficiency letter issued; all you had was the Revenue Agent's report, showing the taxpayer's consent to an 870 deficiency letter?

A. That is correct. That was in order to expedite a determination of the case, however, Mr. Winter, as you know.

Q. Then the tax was paid and a suit for refund was brought? [322] A. Yes.

Q. A claim filed and suit for refund brought?

A. Yes.

(Testimony of Garthe Brown.)

Q. You prepared the claim for refund, didn't you?

A. I assisted in it. I did not prepare it. Mr. Jacob——

Q. Did you prepare the returns for the taxpayer for the years 1942 and 1943?

A. I do not believe in either of these years I prepared them. I believe in 1943 I assisted Mr. Jacob with some computations, because I was familiar with it, and went over it with him.

Q. Now, you say the books were kept on an accrual basis. You mean the accounts were kept on an accrual basis, don't you?

A. Well, the accounts in the books.

Q. How were the contracts kept on the books, the long-term contracts?

A. Well, the items of expense were charged to the particular contract involved and as items of income became billable they were billed and accrued to the contract.

Q. No inventory of stock piles or percentage of contracts that were not complete were set up on the books?

A. No, no inventory set up because it wasn't necessary.

Q. No consideration given for cost of construction for which they would not be able to bill the owner, isn't that right?

A. That is correct; only items that were billable when the work was in such state that it could be billed were set up on the [323] books.

(Testimony of Garthe Brown.)

Q. You heard the testimony of the last witness or the next to the last witness, Miss Novak, the bookkeeper, that part of the December work, work which commenced in December, was accrued and set up on the books as income in 1943?

A. That is correct.

Q. Would you say that was good accounting practice?

A. It was. My understanding of that particular item that you are referring to, Mr. Winter, is that that item was not billable on December 31st; as a matter of fact, over two months there was less than one-half of one per cent of that particular job completed.

Q. How about the work in progress?

A. Well, you mean between November 30th——

Q. Yes. A. ——and January 31st?

Q. Yes.

A. On that particular job, we checked with the engineers, and there was less than a half of one per cent of the work completed over that period that could have been billable.

Q. Take this Milwaukie Housing Project, income \$7,634.90 and only a cost of \$575. Would you say that part of the report clearly reflects the income in that particular year?

A. In that particular item, there was a dispute as to whether the money was available and disputed items are not to be taken [324] as income until the dispute is settled. The expenses had been incurred and, therefore, it is a legitimate accrual.

(Testimony of Garthe Brown.)

Q. The expenses that had been incurred for an item that was in dispute, you say if the income is not accruable, you say the expense is accruable?

A. Well, let me explain.

Q. Just answer the question, Yes or No. Can you answer that Yes or No? A. No.

Mr. Bischoff: I think counsel should give the witness a chance to answer.

The Court: Go ahead.

A. As to this particular item, Mr. Winter, everything that was billable had been billed and all expense that had been paid had been paid and accrued, and I would say that would be a proper method of handling that, because all the money that the company was going to collect had been billed. They might have had to spend \$7,500 to complete it. In fact, that was their testimony. Therefore, that would not have been income then because they would not have gotten any more from the project.

Q. (Mr. Winter): Do you mean to tell me, Mr. Brown, with your experience as an accountant, that if it cost \$5,000 in expenses in connection with one item, and it is a disputable item and you don't know whether you are going to get paid for it or not, that you should accrue the expense in the year in which it was incurred, [325] or do you accrue it at the time you accrue the income, for good accounting practice, or do you set it up as work in progress?

A. In the first place, work in progress is not required of the contractor.

(Testimony of Garthe Brown.)

Q. We are assuming that. As to whether or not it is required is another question, but I am assuming that it is required.

Mr. Bischoff: You should include it in your question, then.

A. The money for this particular work, in your hypothetical question, having been expended, with no chance of recovery, a dispute existing as to whether or not you are going to collect it—you certainly have spent the money and are entitled to deduct that item.

Q. (Mr. Winter): The books of the Ross B. Hammond Company do not reflect work in progress; no adjustment is made for work in progress?

A. That is correct.

Q. No adjustment is made for materials on hand, not billed for? A. That is correct.

Q. How do you account in the books for income received of \$1,036,000 on one contract and costs of \$20,000, excessive costs over income? How do you account for that distortion of income or apparent distortion of income?

A. The explanation, I think, is that on that part of the contract they were losing money; the costs were exceeding the rate they [326] were able to bill and in a later year an adjustment was made whereby they were able to make up that difference and, of course, having expended a good deal of money getting started, they came back in the last half of the contract, because they got a larger amount of work.

Q. In other words, from the books you determined they had a 50-per cent profit on the contract

(Testimony of Garthe Brown.)

in 1942, and where they had \$1,000,000 they had a 20-per cent loss—a \$20,000 loss, is that your contention?

A. That is on the particular part of the contract they were working on, yes.

Q. You did not determine that there may have been a considerable amount of work in progress for which they could not bill in 1942 and that was billed in 1943, did you?

A. There was no work in progress to be done.

Q. You didn't know it at the time? The books didn't show it?

A. The books reflected no work in progress.

Q. They do not show any work in progress?

A. That is right.

Q. You didn't know whether there was work in progress at that time, did you?

A. I didn't know whether there was work in progress, that is true.

Q. You don't know whether there may have been a million dollars of work in progress at that time?

A. Other than that we did check it and determined that particular [327] contract was a loss contract.

Q. Is that the reason why, in the next year, 1943, they had \$93,000 profit with only \$274,000 in income?

A. That is explained, I believe, because of the fact they went into the contract and they incurred items of expense in the first half and then, getting

(Testimony of Garthe Brown.)

an additional contract, these items do not have to be purchased again and, so, there was a larger amount of profit.

Q. This is the same argument as when you were representing the taxpayer, as **attorney for the taxpayer**, in the conferences?

A. That is correct.

Q. But you also admitted at that time, that there was a considerable distortion of income, didn't you?

Mr. Bischoff: Objected to as incompetent. A disclosure of negotiations, I submit, is not competent here in the trial of the case.

The Court: Where he takes the witness stand, I think it is. Objection overruled.

Q. (Mr. Winter): Isn't that right?

A. In the conferences, as a method of arriving at a settlement, I stated that if the Government would admit a partnership existed, we would go along on that. I never did agree with you, however, as to that point of making the concession that the accounting was not proper and hesitated——

Q. (Mr. Winter): Mr. Brown—— [328]

Mr. Bischoff: Wait a minute. Let his finish.

Mr. Winter: I thought he had finished. Go ahead.

Mr. Bischoff: You wait.

A. In the process of the settlement we raised the question that we wanted to sustain the accounting for the reason that the Government's method was so improper that we would have kept at it a year making three years' prior returns and

(Testimony of Garthe Brown.)

much time would be involved in preparing tax returns for the Ross B. Hammond Company, preparing returns for three or four or five past years, depending on how long the contract lasted; and we also said in those conferences that in our opinion that these distortions were bound to occur; that you could level them off by hindsight, which is the way Mr. Williams did in his report——

Q. He did it on a per cent of the cost?

A. That is right.

Q. Percentage of the profits?

A. That is right.

Q. Spreading it out over the length of the contract?

A. That is just as illogical, and we argued at that time that in any job it is only logical that on some portion of it they would make a greater rate of profit than on another, and by taking the money and spreading it out in that way, it certainly is not good accounting practice. It is not good accounting.

Q. Is it possible to take these books and records and show the amount of work in progress at the end of a year and the [329] amount for which no billings had been made, and then adjust the returns to arrive at the correct income?

A. By the books and records it is not possible to determine the work in progress. We didn't feel it was necessary.

Q. You did not feel taking into consideration the inventory was necessary?

A. That is correct.

(Testimony of Garthe Brown.)

Q. It is not possible from the books to arrive at a more proper allocation of income for these years except on a basis as used by the Commissioner?

A. The basis used by the books would be a more logical basis than that used by the Commissioner in that they more truly reflect the income, as earned. They reflect the less profitable contracts as well as the more profitable.

Q. Is a \$93,000 profit on a \$184,000 cost more reasonable than—Would you say that \$93,000 on \$184,000 is a reasonable profit, costs of \$182,000, about? Would you say that is a reasonable profit?

A. I would not say it is a reasonable profit unless——

Q. Wait a minute. You have answered the question.

Mr. Bischoff: Let him explain it.

A. Unless I knew the facts, because that has happened in many businesses, where, through circumstances of a loss in one year and a profit in another year, that situation might be disclosed.

Q. Would you say that \$7,058.97 is a reasonable cost with— [330] Would you say that \$7,058.97, with a cost of \$575.12, is a reasonable profit? Do you think that is a reasonable profit?

Mr. Bischoff: Objected to, your Honor, as an improper premise because of the fact the evidence now discloses that represented work that was done in December and the expenditures made in January. He is including an erroneous premise in his question.

(Testimony of Garthe Brown.)

The Court: Mr. Brown knows. I think he can explain that.

A. If the matter were not explained, I would say it was an unreasonable profit, but an explanation has been given as to why it occurred.

Q. (Mr. Winter): On an accrual basis you have only accrued \$575.12 in costs and \$7,058.97 profit, over \$7,000 more.

Mr. Bischoff: I want to object to the question and to further examination along this line upon this basic proposition: That it is fundamental to this case, as to what is meant by "clearly reflect the income."

I called your Honor's attention to the decision of the Supreme Court which settled that question once and for all. I rather believe if that decision had been known to the Revenue Agent at that time he would not have made the report that he did.

The contention was made in that case that the term "clearly reflect the income" must mean that it must clearly reflect the income in a given year, and the Court rejects that [331] contention in no uncertain terms.

The Court said:

"The rationale of the system is this: 'It is the essence of any system of taxation that it should produce revenue ascertainable and payable to the Government at regular intervals. Only by such a system it is practicable to produce a flow of income and apply methods of accounting, assessment, and collection capable of practical operation.'

(Testimony of Garthe Brown.)

“This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt of payment, or, applying to accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.

“But the petitioner urges that (Sec.) 43 has altered the rule so that a hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for these annual accounting periods. It urges that the change was due to the desire of Congress to prevent distortion of true income. This must mean distortion of true income, not of a given year, but in the line of ultimate gain from a series of transactions over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year.”

(*Security Mills Company v. Commissioner of Internal Revenue*, 321 U.S. 281.) [332]

The Court: Where did you read from?

Mr. Bischoff: I have been reading from the Supreme Reporter, at the very last section of the opinion.

The Court: What Supreme Reporter is that?

Mr. Bischoff: 64 Supreme Court Reporter 596. I read to your Honor from the bottom of page 598 and 599.

I do not want to take your Honor's time—it is getting late—to read other pertinent portions of the opinion, but the Court there makes a complete

(Testimony of Garthe Brown.)

analysis of this system of accounting, the accrual and cash basis, and points out the impossibility in any system to clearly reflect income in a true and certain sense because, as they point out, under no system, when you get to the end of a year, are you always able to determine the income, because there may have been bills which may have been incurred but not received or, on the other hand, conditions may be reversed.

The Court: You took a half day to educate me on the different points of the case, so I still have them in mind. It may be that the Supreme Court might change its mind as it so very often does these days.

Mr. Bischoff: At the present, obviously, I assume we are all bound by it and, if we are, then this line of examination is all beside the point. The Supreme Court says that the test is: Is there a clear reflection of income over the period of the years in which that transaction was involved? [333]

The Court: Mr. Brown, being a lawyer, knows what the rules are. Answer Mr. Winter's question, in the light of your position of being required to render an opinion, whether this reflected income, undistorted. That is the question. Go ahead and answer it.

A. My opinion, Mr. Winter, is that the profits from this particular contract are reflected properly, in light of the explanation that has been given here in the courtroom.

(Testimony of Garthe Brown.)

Mr. Winter: Although you admitted to me and to Mr. Williams, in conferences, that there was a considerable distortion of income.

A. In the conferences we were discussing the fact——

Q. You were willing then to admit——

Mr. Bischoff: Let him answer.

A. At no time, Mr. Winter, did I any more than state that it would be just a matter of trading horses with the Government, just to settle the case out of court.

Q. You offered to accept the Commissioner's determination?

A. I did not. I believe you are wrong. I offered to take that and discuss it with Mr. Jacob, and that was the result of the conference. I stated that if I were you it would be a good offer to take up because I knew, from having made calculations, that we would get practically the entire refund if the accounting issue were lost, which was actually the case, and I assume it was because we would get practically the entire refund that the [334] Government backed down on its offer.

Q. The Government did not make an offer, did it?

A. You submitted an offer, Mr. Winter.

Q. After you submitted it to me.

A. No, you submitted the offer. I did not.

The Court: How much was it? Don't get so stirred up here. How much in dollars? How much did the Government offer to settle for?

Mr. Winter: We never arrived at a dollars-and-cents basis.

(Testimony of Garthe Brown.)

The Court: How much, in dollars?

A. Your Honor, we would have received a refund of between \$120,000 and \$145,000. The reason we wanted to accept that offer——

The Court: I do not want your reason.

Mr. Winter: The offer of settlement is contained in the exhibits.

Mr. Bischoff: I did not know it was.

Mr. Winter: Yes, here are the computations, Exhibit 29.

Mr. Bischoff: That is your computation.

Mr. Winter: This is the Commissioner's computation of the amount.

The Court: He said the lawsuit is over \$145,000 and you offered to settle for \$20,000 less. Is that what you just said?

A. That is right. That would have had the effect of a recovery of all but about \$20,000. [335]

Mr. Bischoff: Will you clarify that?

Mr. Winter: Yes. This is not the amount of the offer.

The Court: At this time we will adjourn until 10:00 o'clock in the morning.

(Thereupon, at 5:15 o'clock p.m., an adjournment was taken until 10:00 o'clock a.m., January 15, 1948.) [336]

Court reconvened at 10:00 o'clock A. M., January 15, 1948.

Mr. Bischoff: Before we proceed, may I make an inquiry? At the outset, when we introduced the exhibits and the Internal Revenue Agent's reports

were introduced in evidence, Mr. Winter submitted to Your Honor a copy that he says he prepared. We did not have a chance to examine it, and I would like to have an opportunity to see it.

Mr. Winter: That is copied from the exhibits attached to the Revenue Agent's report. My secretary copied them.

Mr. Bischoff: This is not an entire copy of the Revenue Agent's report. It only represents the basis upon which his computations were made and his statement as to the reasons for it and the fact situations upon which it is predicated have not been attached, and we would like to submit to you, instead of this, a complete photostatic copy of the exhibit, which is a little easier to read, containing the entire report, and not merely a computation.

Mr. Winter: You misunderstood. That has not been offered in evidence. I merely gave it to the Court when we were talking about these contracts. I am not offering it.

The Court: I will accept it in the nature of a brief.

Mr. Bischoff: We have a photostatic copy of the complete computations. The significance of them cannot be understood [337] without reading the fact situation upon which the Commissioner predicated it.

The Court: Give me both of them, then.

Mr. Bischoff: May we, instead, submit the complete record?

Mr. Winter: Along the lines of that report, the question came up last night as to computations, and I want to hand Your Honor Defendant's Exhibit No. 29. That has been identified as a re-computation prepared by the Commissioner of Internal Revenue, Income Tax Unit, on the basis of the offer which we were discussing, disclosing the tax liability which would be due had the offer been made and accepted by the Commissioner, disclosing a deficiency of \$3,156.41 for the years 1942 and 1943 and substantially, I think, about \$12,000-odd overpayment for 1941, but a deficiency of \$50,000 against William A. Hammond, that being that the Commissioner recognized that a partnership existed, 75 per cent in Mr. Hammond and 25 per cent in William A. Hammond and conditioned that the method of accounting as adopted by the Commissioner, with deductions which the Commissioner contends were necessary, be accepted; in other words, by not allowing as accruals the accruals to Mr. Mason and Mr. Petersen, on which we have ample evidence. That is all that was submitted for, to show what the tax liability would be if the offer was accepted upon that basis, and not as \$103,000. That is out of the picture entirely.

Mr. Jacob: I would like to say this: The matter of the deductions [338] of the accrued profits to Mason and Petersen was not challenged by the Internal Revenue Department. They were left as they were accrued on the books. The offer that was submitted at the request, by the way, of Mr. Winter——

Mr. Winter: I beg your pardon, Mr. Jacob. You refer to your letter and you would not make that statement. Refer to your letter of November 29, 1946: “. . . . If you will indicate what kind of a settlement you would be willing to recommend, we should be glad to receive it.”

Mr. Jacob: That was written at your request.

Mr. Winter: Yes, I told you you had to make the offer.

Mr. Jacob: Yes.

Mr. Winter: I told you what I would recommend.

Mr. Jacob: The difficulty is in the computation Mr. Winter has made he has disallowed the deductions to Mason and Petersen which were conceded as proper at the time the report was made.

Mr. Winter: No, they have never been conceded by the Commissioner.

Mr. Jacob: They were accepted.

Mr. Winter: The Commissioner of Internal Revenue has never conceded them. He did not accept the report in that respect.

Mr. Jacob: He did not challenge them. Now, the facts are that the offer I made—and I very specifically set forth the basis for it—was contingent upon the adjustment of the Mason and Petersen amounts, on the basis of the income as computed by [339] the Internal Revenue Agent.

In other words, instead of allowing 20 per cent of the profit that we showed on the books for Mr. Mason in 1942 and 15 per cent of the profits to Mr. Petersen in the year 1942, by the transfer of

the profits from 1943 to 1942, that would, of necessity, increase the amount of profits that went to Mason and Petersen, so, at the suggestion of Mr. Winter, that they would concede the partnership issue if we could get together on the accounting issue, I submitted that.

The computations were made by Mr. Brown and Mr. Williams, here, and the refund that they arrived at by their computations, for 1942-1943, was \$102,166.10, plus interest.

Here is a letter from the Attorney-General, October 15, 1947, to Ross B. Hammond or, rather, re Ross B. Hammond vs. Maloney, Civil No. 3078:

“You submitted an offer in the above-named case whereby the Government would waive the partnership issue involved, beginning January 1, 1942, and division of the profits would be made in accordance with the Revenue Agent’s report dated November 6, 1944; according to a recomputation prepared by the Internal Revenue Agent the refund due the taxpayer under this offer would be \$102,166.10, plus interest. This is to advise you, after careful consideration, the offer has been rejected by the Attorney-General.”

In addition to that refund, there would have resulted [340] a retention of the refund for 1941, amounting to \$6,536.10 and, by reason of the fact that, in computing the 1942 and 1943 income, the Revenue Agent took out of the year 1944 some \$24,000, there would have been a refund also, as a basis of this adjustment, for the year 1944 of \$12,536.81.

Adding those three together, we get a total, with a refund of the interest that was paid—the total refund we would have received under the proposal that was made would have been \$148,160.11.

At the time this discussion was had I was not present. Mr. Brown was there, but the concession with respect to the accounting was made purely for the purpose of effecting a settlement and we considered, in the long run, the actual facts would work themselves out, and we were prepared to enter into negotiations, and were in agreement with the Internal Revenue Department as to the basis.

The issue then that evidently disturbed the settlement was bringing in this Mason and Petersen issue, which was not in the case until after the offer was submitted. That ultimately, Mr. Bischoff points out, gave rise to the attempt on the part of the Department to file, by way of an intervention suit, an amended answer.

Mr. Winter: If Your Honor please, Counsel has been talking about the counterclaim or the offset that the Government was trying to assert in the case by having the United States made a [341] party, for which a separate suit has been brought. That is only a defense to the plaintiff's contention.

The plaintiff says, "I did overpay my tax. I think I am entitled to a refund." The Government says, "You did not overpay your tax. You did only not overpay your tax, as shown by your computation but, if the proper accruals are made, you owe an additional \$3,000," even conceding that the partnership actually existed, that this secret part-

nership actually existed. Of course, if the partnership did not actually exist, there is a substantial deficiency.

Mr. Bischoff: I want to correct Mr. Winter's statement regarding the nature of the defense which he tendered. He tendered two defenses in the amended answer and subsequently started a new suit, and attempted intervention, but in the amended answer he filed in this court, and which he asked leave to file, the first one is labeled "Additional Defense."

Mr. Winter: Yes.

Mr. Bischoff: The allegation of the "Additional Defense" is: "Defendants are informed and believe and upon such information and belief allege that income of the alleged partnership for the year 1942 in the amount of \$86,635.88 was not reported by or taxed to plaintiff; that income of the alleged partnership in the year 1943 in the sum of \$77,-366.37 was not reported by or taxed to plaintiff."

Then, in the next paragraph, he points out the transactions [342] out of which these two items arose, and points out that they represent the share of the profits allocated and credited to Petersen and Mason for those two years. That is the matter that Mr. Jacob attempted to reserve in the settlement and made it a condition that they be recognized as entered on the books.

Mr. Winter: Well, it seems to me——

Mr. Bischoff: Those contentions were barred by the statute of limitations.

Mr. Winter: I cannot understand how any ques-

tion of statute of limitation can be raised in this case as to whether or not a taxpayer has overpaid his tax or not. That is still a question for the Court to determine.

In other words, the Court has got to determine in this case what tax the taxpayer actually owes and what tax he paid. In other words, the Court has got to determine from his returns exactly what tax liability this—what the tax liability of this taxpayer was for that year. He has said he has overpaid the tax by the sum of \$175,000. What are the facts? What was the taxpayer's true tax and how much did he owe?

We will submit substantial and ample authority to the effect that if the taxpayer has not overpaid his tax upon any basis he cannot recover in this action, no matter what it was. In other words, if the Court can find on its own motion that some of these deductions were not proper, he cannot recover. The taxpayer's counsel has been advised of this contention of [343] the Government for many moons.

Mr. Bischoff: The briefs we submitted cited many cases to the effect that even in a tax refund case you cannot bring into issue, for the purpose of reducing or increasing the amount involved, consideration of items which have been barred by the statute of limitations, and I assume Your Honor had those decisions in mind when the ruling was made.

GARTHE BROWN,

a witness on behalf of plaintiff, having been heretofore duly sworn, resumed the stand and further testified as follows:

Cross Examination (Cont'd.)

By Mr. Winter:

Q. Mr. Brown, you testified, you, in company with someone else, went down to examine the books and records of the Hammond Company. Was that before or after the investigation by the Revenue Agent?

A. That was after the investigation, Mr. Winter. It was in the year 1946.

Q. In 1946?

A. That is correct, in the month of November.

Q. In the month of November?

A. That is correct.

Q. How long were you down there?

A. I put in, I would say, roughly the equivalent of about two weeks of my time during that period. I was working day and night [344] during the week we were there and at least some time in another week.

Q. Who were "we"?

A. Mr. Johnson of our office and Mr. Peterson of our office were also over there.

Q. Mr. Johnson and Mr. Peterson?

A. That is correct.

Q. However, at that time you did not see all the books and records of the company, did you?

A. I saw all of them that are before us here.

Q. I think you testified you did not have access to the cash journal?

(Testimony of Garthe Brown.)

A. No, the trial balance. We made up our own trial balance while we were there.

Q. When was the first time you learned that the partnership existed?

A. I have known the partnership existed ever since practically I became associated with Mr. Jacob. In fact, my first knowledge of it was when I was discussing with him a draft of Articles of Partnership and he suggested that the other agreement I was drafting—That was in May of 1943—would be similar to the Hammond Articles, that it happened to be in a similar situation, and that I read those over as a guide in order to draft my other Articles, so I have known of it ever since I knew Mr. Hammond was a client of our office.

[345]

Q. In 1943; you used a draft made up then?

A. A copy of it was in our files at that time.

Q. In 1943? A. That is right.

Q. That is when you used it in connection with the preparation of another form of partnership agreement in some other case?

A. That is right.

Q. You say that these books were kept on a strict accrual basis?

A. That is correct.

Q. That is, the accounts?

A. That is right.

Q. Under a strict accrual system of accounting is it possible, under income tax law, in your opinion, to accrue contingent liabilities?

A. No.

Q. Not legally enforceable? A. No.

(Testimony of Garthe Brown.)

Q. Until some future date? A. No.

Q. Therefore, if any items were accrued on the books which were contingent liabilities, not presently legally enforceable, they would not be proper accruals, would they?

A. That would be correct.

Q. Was there anything on the books to indicate that a partnership existed as of February 3, 1942? [346]

A. There was nothing on the books and records here. The only thing would be the agreement which we knew of.

Q. The agreement was not in the books and records? Was it?

A. No. It was kept in the files of the company and in our files.

Q. How do you know where it was kept?

A. I know we had a copy in our files.

Q. Did you keep the income tax returns of the company? A. No.

Q. I mean, did you prepare them?

A. The first return I believe I worked on was the year 1944, and I did some checking of the year 1943 return. Of course, I knew of the partnership long before that time.

Q. Did you prepare the amended returns?

A. If I had anything to do with them, it was a recheck of the computations. I believe Mr. Jacob asked me to do that, after he prepared them.

Q. You know that the books and records deducted the same percentage of profits to Bill Hammond from the contracts that they did with respect to Mr. Petersen, isn't that right?

(Testimony of Garthe Brown.)

A. As I recollect, without checking, the amount to Mr. Petersen was deducted and then the amount to Mr. Bill Hammond was deducted.

Q. Are you sure about that?

A. I would want to check the books.

Q. Just refer to the books and tell us what amount was deducted [347] from the income of the Ross B. Hammond Company for profits to Mr. Petersen for the year 1942?

A. May I have the ledger there?

Q. Look at Journal Entry J-125.

Mr. Bischoff: You find it in your own way. You find the things he asks for wherever you want to find them.

Mr. Winter: I was going to save him a little bit of trouble.

A. What year are you referring to, Mr. Winter?

Q. I am referring to 1942, the profit which was deducted from the contracts on behalf of Mr. Petersen, the profit to Mr. A. V. Petersen for the year 1942. A. \$37,129.66.

Mr. Bischoff: Louder. A. \$37,129.66.

Mr. Winter: Q. What was the amount deducted on the books and records as profit to W. A. Hammond?

A. On this particular transaction, \$37,129.

Q. For the entire year?

A. I would have to go back and check it.

Q. Didn't you check that when you checked the records?

A. That is a year and two months together. I would have to go through my working papers.

(Testimony of Garthe Brown.)

Q. Will you show us from the books what percentage of profit Mr. A. V. Petersen was entitled to under his profit-sharing agreement? Before you answer that question, I will withdraw it. [348] Where was that deducted from, what contract?

A. From Jobs 208, 210 and 211.

Q. Just find how much was accrued to Mr. A. V. Petersen for the year 1942?

A. I believe it was \$37,129.60, the amount to Mr. Petersen on the books.

Q. Are you sure about that?

A. I would have to go through the working papers.

Q. What was accrued on the books to the salary account of Mr. W. A. Hammond? I will ask you to refer to Exhibit 33 and see if you don't find that entry there made. A. \$37,129.

Q. In other words, the same amount was accrued on the books to A. V. Petersen that was accrued to W. A. Hammond, although W. A. Hammond had a contract for 25 per cent of the total profits? A. That is correct.

Q. That is only 15 per cent of the profits for the year, isn't it?

A. That is correct, but to the extent of Mr. Hammond's participation in the business and partnership, that would not be reflected on the books because it had not been recorded.

Q. No capital account was ever——

A. No capital account for Mr. W. A. Hammond.

Q. No capital account was ever set up for his partnership profits until 1944, was there? [349]

(Testimony of Garthe Brown.)

A. That is correct. That is quite common in partnerships.

Q. I didn't ask you whether it was very common. I said none was set up, was there?

A. That is right.

Q. In other words, deducted from the contracts, and take a deduction from income of not only the profit to Mr. Petersen and Mr. Mason, but a profit of 15 per cent accrued to W. A. Hammond?

A. That is correct.

Q. No capital account appearing on the books?

A. That is correct.

Q. As a matter of fact, no capital account was on the books until 1945, was there?

A. I believe that is the year that was put on.

Mr. Bischoff: Do you still want the witness down here, Mr. Winter?

Mr. Winter: No. He may resume the stand.

Q. Did you attempt to make any adjustments of any part of the income of this company for the years 1942-1943? A. No.

Q. As a matter of fact, it was impossible to find out from the books or take from the books the value of any stock piles or work in progress as of the end of each year?

A. That is correct. The books show no inventory.

Q. It would be impossible to determine the profit on a strict [350] percentage-of-completion basis, wouldn't it? A. Mr. Winter—

Q. Just answer my question. Would it or would it not be possible?

(Testimony of Garthe Brown.)

Mr. Bischoff: He cannot answer. It is not answerable.

Mr. Winter: Q. Just answer my question. Would it or would it not be possible from the books to now compute the profit on the long-term contract upon a percentage-of-completion basis?

Mr. Bischoff: Objected to, may it please the Court. The test is the ability to make a report that would clearly reflect the income when a party makes a return; not now.

The Court: He may answer.

A. I will answer, yes, but I want to qualify that with a statement that, since inventories are not necessary, therefore we do not need them to prepare a return on the accrual basis.

Mr. Winter: Q. I did not ask you that. I said if you were going to report the profit from these long-term contracts on a strict percentage-of-completion basis, would it be possible to determine the profit on that basis from these books and records?

Mr. Bischoff: Objected to, may it please the Court, as immaterial. We do not claim that we reported on a percentage-of-completion basis, Your Honor. The issue here concerns only the question whether we have adopted the accrual method and whether it was properly kept.

The Court: He may answer, subject to the objection. [351]

A. From the books you could not report on a percentage-of-completion basis.

Mr. Winter: Q. In other words, the books were not so kept that you could report the true

(Testimony of Garthe Brown.)

income from these contracts on a percentage-of-completion basis? A. That is correct.

Q. Of course, it is your contention, as counsel for the plaintiff, representing the plaintiff at least in these proceedings, in the proceedings leading up to this, that under the accrual method of accounting it is not necessary, under the statute and regulations, to keep any inventory of stock piles at the end of the year or make any estimate of work completed but not billed at the end of the year. That is your contention?

A. It is our contention no inventories are necessary.

Q. Are you also contending that inventories are not necessary when the billing is based upon a percentage of the completion of the contract at the date of billing?

Mr. Bischoff: Objected to as immaterial in this case, Your Honor, because we are concerned only with the accrual method.

The Court: Answer.

(Question read.)

A. On the accrual basis of accounting, it is not necessary.

Mr. Winter: Q. It is your contention it was not necessary, in order to reflect the income, to make any estimate of uncompleted work or stock piles at the end of the year? That is your [352] contention?

A. That is correct. They billed each month and that would be included in the latest billing.

(Testimony of Garthe Brown.)

Q. Do you know of any other method, other than that adopted by the Commissioner, which would more clearly reflect the income during each taxable period?

Mr. Bischoff: Objected to as immaterial. We are concerned with what was done in this case.

The Court: He may answer.

A. I feel the method adopted by the taxpayer reflects it more fully than that adopted by the Commissioner, for the reason that the income from the period is all being reported as he is entitled to it; all accruals were taken into account; and it is as complete, I think for a taxpayer, as any other basis of accounting that he could adopt and truly reflects his income as closely as any other basis that he could adopt.

Mr. Winter: Are you basing that opinion—the method adopted by the Commissioner reflects the total income, reporting as to those contracts the percentage of profit in each year, based upon the work and labor performed in that year. You say that is not a good method?

A. That is right, because the percentage of money earned in a year on any job will vary. One particular contract might be very profitable; another might show a loss. The method adopted by the Commissioner would not reflect that. [353]

The other error in his method is that you are always going to have to go back and refigure the past two or three years in order to determine your income for any year, and that is not a good method of accounting.

(Testimony of Garthe Brown.)

The law requires that you determine your income each year and, therefore, because of that requirement, I feel the method adopted by the taxpayer does comply with that requirement.

Q. Regardless of the fact that a considerable amount of work had been done and money expended in one year for which he could not make a billing, because of some technicality, that would clearly reflect the income, is that right?

A. That is right.

Q. In other words, you think that more clearly reflects the income than if he showed a percentage of profit in each year?

A. That works in any line of business. You will see such distortions, as you call them, of income.

Q. If you have——

Mr. Bischoff: Let him get through.

A. I am familiar with one case of a tent manufacturer where, during their first year, they lost heavily and, in negotiations with the Government, they stated that it was only logical that when a contractor started that during the first year of operation he would have a liability because of the high rate and when he got into production he would begin to show a high rate of profit in the other years. [354]

Q. But this contractor had been in business since 1920?

A. That is correct, but on each job he had unprofitable parts and certainly his rate of profit is going to vary; depends on the portion of the job that the contractor is working on.

(Testimony of Garthe Brown.)

Q. Of course, you are very much interested in the result of this lawsuit, aren't you?

A. I haven't any interest in the result of it, Mr. Winter.

Q. You are a member of the partnership, Jacob, Jones & Brown? A. That is correct.

Q. You have been employed by the taxpayer; you were employed by Mr. Jacob to work on this case in 1946? A. That is correct.

Q. That is where you were paid your salary?

A. Yes, that is correct.

Q. And you say you don't have any interest in it?

A. Well, I have a natural interest in the taxpayer as a client, the same as I would any other client of the office, but so far as any added remuneration should this case be determined one way or the other, that would make no difference to me.

Q. As a matter of fact, when you filed the protest in this case, you were given opportunity to show on what basis it would more clearly reflect the income than that adopted by the Commissioner?

Mr. Bischoff: That is objected to as immaterial. We only have this one issue here.

The Court: He may answer. [355]

A. In filing of the protest, Mr. Jacob handled that part of it. I do not recollect being allowed to give the Government any other basis.

Mr. Winter: You went down and made your protest—made your investigation, rather, after the protest was filed?

(Testimony of Garthe Brown.)

A. Our investigation was made preparatory to the case coming on for trial, and it was set for pre-trial a year ago. We spent perhaps a month to familiarize ourselves with the books and the method of accounting employed, and also for the preparation of the protest there was an examination made.

Q. You say that a method of accounting, in connection with long-term contracts, which does not make any allowance for stock piles of materials on hand or percentage of work completed clearly reflects the income? That is your contention?

A. Clearly reflects the income over the years, that is correct.

Q. Supposing, Mr. Brown, that you adopt an accrual method of accounting in the books and that during the last three months in a year considerable work was expended, time and material and labor expended on the job, and no billings were made until the end of the year and, since no billings were made, no income was accrued: Would you say in that case the books clearly reflect the income on the accrual basis?

Mr. Bischoff: That is objected to, may it please the Court. It is purely hypothetical. That is not the situation here. There is no evidence in the record to support that hypothesis. [356]

The Court: He may answer.

A. If the taxpayer did not bill when he was entitled to bill, and let it go deliberately, that would not clearly reflect the income, but if he billed

(Testimony of Garthe Brown.)

his billings that he was entitled to over that period because of the terms of the contract, then, it would clearly reflect the income, because he would have received all he was entitled to receive.

Mr. Winter: Q. I am assuming that all the work during the past three months was such that under the terms of the contract considerable expense had been incurred, such as labor and materials,——

A. Yes.

Q. —but under the contract it was not possible to bill for all the work and labor and materials until after the first of the next year, and the accounts were kept on an accrual basis: Would you say, in that event, the books would clearly reflect the income?

A. Again, over the years, they would.

Q. Over a period of years but not during the taxable period, during the last three months?

A. If such was the case under your hypothetical question and if considerable money were spent in that year, obviously not.

Q. In other words, if \$1,057,409.83 was spent in the first nine months, I mean spent during the year, in the cost of labor and materials on a job, but they could not bill for the last three [357] months for unfinished work or work which had not been accepted as yet because of some minor defects, would you say that the income during that year would be clearly reflected?

A. Are you referring to our case now?

Q. I am referring to a situation such as this.

(Testimony of Garthe Brown.)

Mr. Bischoff: Objected to as purely hypothetical, in nature, not within any issue in this case.

The Court: You will have a chance to present your case.

Mr. Winter: I was using substantially the figures in this case but I am using them as a hypothetical question.

The Court: Yes.

Mr. Winter: I want to shorten it if I can.

The Court: You are using one of the contracts in this case?

Mr. Winter: Yes, I am using the figures in the Troutdale contract. I am assuming them for the purpose of my question.

The Court: Treat it as if it applied to the Troutdale contract.

A. If the work were not billable at the time——

The Court: You know what the facts are.

A. In that particular case, since the work had been billed, they do clearly reflect the income on that portion of that particular job.

Mr. Winter: Q. Would it not indicate to you that considerable more work had been done than the amount for which they were able to bill? Wouldn't that be indicated to you? [358]

A. In that particular one, Mr. Winter, we checked and we found they were not able to bill any more; they had billed everything they could; as a matter of fact, they sustained a loss on that particular contract.

Q. There is no record in there anywhere as to work partially completed as of December 31st is

(Testimony of Garthe Brown.)

there? Is there anything in the books to show what stock pile was on hand December 31st on that job?

A. Mr. Winter, you know——

Q. Answer my question.

A. There was nothing on the books to determine the stock pile.

Q. In Troutdale? A. Yes.

Q. And there was nothing in the books that you found which would show uncompleted work for which they could not bill as of that date, was there?

A. That is correct.

Q. Nothing in the books to show, in connection with any of the contracts, the amount of stock pile or uncompleted work for which they could not bill?

A. That is correct.

Mr. Winter: That is all.

Redirect Examination

By Mr. Bischoff:

Q. Mr. Brown, was there anything in the books to indicate that [359] there was in fact any stock pile?

Mr. Winter: Object to that.

A. Nothing to indicate it.

Mr. Bischoff: Just a moment.

Mr. Winter: He is not asking for something on the books. He is asking for something that is not on the books.

The Court: Go ahead.

A. Nothing on the books to indicate that there was any inventory of stock piles.

Mr. Bischoff: That is all.

(Testimony of Garthe Brown.)

Recross Examination

By Mr. Winter:

Q. There was nothing on the books about any inventory of stock piles? A. That is correct.

Q. The books were absent of any reference to that? A. To any inventory, that is correct.

The Court: Step down.

Mr. Winter: Q. But every cost that had been incurred, whether paid or not, had been accrued?

A. That is correct.

Q. All labor up to December 31st?

A. That is correct.

Q. All materials ordered or billed up to December 31st? A. That is correct. [360]

Q. As to whether or not it was a part of any of these estimates, you would not know, would you?

A. We checked those and determined the estimates were billed as far as could be billed.

Q. In accordance with the contracts?

A. In accordance with the contracts.

Mr. Winter: That is all.

The Court: Step down.

(Witness excused.) [361]

FRANK H. EISEMAN,

was thereupon produced as a witness on behalf of plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. Where do you live, Mr. Eiseman?

(Testimony of Frank H. Eiseman.)

A. Portland, Oregon.

Mr. Winter: I didn't get his name.

The Clerk: Frank H. Eiseman.

Mr. Winter: What is the first name?

A. Frank H. Eiseman.

Mr. Bischoff: Q. What is your profession?

A. I am a Certified Public Accountant.

Q. How long have you been living in Portland?

A. I have been in Portland since March, 1940.

Q. Are you a member of any state or national organization of Certified Public Accountants?

A. I am a member of the Oregon State Society of Certified Public Accountants and I am also a member of the American Institute of Accountants, which is a national organization of Certified Public Accountants.

Q. How long have you been engaged in the accounting profession?

A. Some fourteen years.

Q. When did you become a Certified Public Accountant?

A. I passed my examination in the fall of 1945. [362]

Q. Where have you practiced your profession?

A. I was engaged for a short while with Whitcomb, Buell, Stratford & Company in the Pacific Building, here in Portland, Oregon, and for four years I was connected with Piepenbrink & Kron, accountants in this city.

Q. Are both of these firms accountants in this city?

(Testimony of Frank H. Eiseman.)

A. Yes. They are both firms of Certified Public Accountants. Since the first of this year I have had my own office.

Q. Mr. Eiseman, did you, at my request, make an examination of the books and records of the Ross B. Hammond Company?

A. Yes, sir, I did.

Q. When did you begin to make the examination?

A. You told me of my engagement on the 31st of December, 1947.

Q. Did you go to work on the examination at that time?

A. I started some of the preliminary work on that very day.

Q. At the time you were employed to make the examination, were you given the Revenue Agent's report in this case?

A. Yes, I was.

Q. That is the report for the year in which this controversy was involved?

A. The report I was given for the year, the combined years of 1942 and 1943. I believe it is called 1943 on the report.

Q. I show you Exhibit 20 and ask you if that is the Revenue Agent's report that was submitted to you for your study?

A. Yes. I saw a photostatic copy of this report. [363]

Q. Did you familiarize yourself with the contentions that were being made in that report?

A. Yes, sir, I did.

(Testimony of Frank H. Eiseman.)

Q. In making that examination of the records, did you do so for the purpose of determining the facts pertinent to these questions that are raised?

A. Yes, sir, I did.

Q. In connection with the examination, did you examine the income tax returns for the tax years referred to in this Revenue Agent's report?

A. I examined the retained copies of the tax returns filed for the years 1939, 1940, 1941, 1942, 1943 and 1944.

Q. State what examination you made of the records? Did you go down to the office of Ross B. Hammond Company?

A. Yes, I went down to the office of the Hammond Company. I was given the general ledger, the journals, the trial balance book and other supporting records I asked for which I felt were necessary for the purpose of the examination I was making.

Q. Did you examine the monthly estimates?

A. Yes, I did.

Q. And all the contracts that were referred to in the Revenue Agent's report?

A. I did not examine all the estimates but I examined some of the estimates on the contracts referred to in the Revenue Agent's report. [364]

Q. Did you examine them sufficiently to state the manner in which they were gotten up and the information they purported to present?

A. I examined several sufficiently to satisfy myself of the method employed in making up the

(Testimony of Frank H. Eiseman.)

estimate and recording them on the books of the company.

Q. Did you make what we might call a partial test check or partial test checks of these monthly estimates into the books to see how they were handled?

A. Yes. I made certain test checks in that regard.

Q. State how long you were engaged in making that examination and to what extent you made the examination of these records?

A. I worked a great deal since December 31st on the examination of the books and records of the company, to the end of last week. The examination was made for the purpose of determining whether the method employed was an accrual——

Q. Did you examine the records for the purpose of determining whether the method employed was consistently followed through the years that you referred to?

A. Yes. That was another purpose of the examination, and I further compared the profits shown on the books with the profits shown on the tax returns.

Q. From the examination that you made, Mr. Eiseman, are you able to state the method of accounting that had been used by the Hammond Company for the years 1939 to 1944, inclusive, was the [365] accrual methods?

A. Yes. The method of accounting since 1939 was the accrual method.

(Testimony of Frank H. Eiseman.)

Q. What did you find from the examination as to the consistency in the maintenance of these accounts during those years?

A. The accrual method was consistently followed on the books.

Q. I call your attention to the list of separate accounts set up on the books of the company as they are reflected in the balance sheet book during the years in question, and ask you to state whether the list of accounts that were set up is proper and adequate for the maintenance of the accrual system of accounting?

A. The trial balance book indicated that the accounts which are important for an accrual method were all kept. I am here referring to accounts payable, accounts receivable, accrued expense, accounts like accrued Federal Social Security, accounts like unemployment compensation, and accrued interest payable and other accounts of this type. Would you want me to read these accounts?

Q. It is not necessary. They have been read into the record, so it is not necessary to repeat them.

Are you able to state whether the income tax returns, as they were made, for the years 1939 to 1940, were in accordance with the accounts as they were kept?

A. Yes, they were.

Q. Did you check to see whether the figures of profit or loss, if any, were exactly as they are in the books? [366]

A. I found in one of the later years a small discrepancy, which was in favor of the Government

(Testimony of Frank H. Eiseman.)

against the taxpayer. The income was slightly overstated on the tax return compared to the books, but otherwise I found full agreement.

Q. How much was the amount of the error?

A. I think some \$300.

Mr. Winter: I do not see the materiality of that.

Mr. Bischoff: Are you able to state from your examination of the books that you made and of the tax returns made upon those books whether the accounts as kept, clearly reflect the income?

Mr. Winter: Objected to as calling for a conclusion of the witness. I don't think this witness can so testify.

The Court: He may answer.

Mr. Winter: He can testify, as an expert, as to what the books show, but as to whether they clearly reflect the income, that is a matter for this court.

The Court: He may answer.

A. The method employed for the years in question clearly reflected the income within the meaning or in accordance with the Internal Revenue Code and regulations.

Mr. Bischoff: You may cross-examine.

The Court: Before you start in, is this some kind of a test case the Commissioner is making?

Mr. Winter: No, Your Honor, it is not a test case at all. The Commissioner is authorized under Section 41, where books are [367] so kept that the income of the taxpayer is not clearly reflected in his returns, to require the taxpayer to keep such

(Testimony of Frank H. Eiseman.)

records or adopt his own method in arriving at the income.

It is the Government's position that they attempted to go on an accrual basis, and they reported on a percentage-of-completion basis, and they got kind of a hybrid situation. I think the record will show——

The Court: "High-bred" or "hybrid"?

Mr. Winter: I don't understand.

The Court: I don't understand you.

Cross-Examination

By Mr. Winter:

Q. Mr. Eiseman, you say the accounts, the books were kept on an accrual basis? A. Yes.

Q. They accrued all liabilities, such as labor and material, that went into the contract as of December 31st, the end of each year?

A. I am talking about the method, not about the accrual dates.

Q. You say the method of accounting was on an accrual basis and, as a matter of fact, the books reflected that they did accrue——

Mr. Bischoff: Answer, instead of shaking your head.

Q. (Mr. Winter): The books did accrue all accounts payable, labor and material, as of the end of each year?

A. The books showed that there were accounts payable. [368]

Q. Yes. Did you check the accounts payable to see whether all these accounts were properly accruable in the years in question?

(Testimony of Frank H. Eiseman.)

A. I did not confirm any of the accounts payable to make sure all accounts payable were set up. I didn't think that a part of my task in this particular case because small errors would not prevent a taxpayer from being on the accrual basis.

Q. I didn't ask you what you thought. I asked you whether or not you did.

A. I did not confirm that all accounts payable had been set up.

Mr. Bischoff: Let his finish.

Mr. Winter: You say you examined a few of the billings. Those billings were all based on the engineer's estimate attached to the billings, weren't they? A. Yes.

Q. How was the profit on the contracts kept on the books? Would you say that was on a strict accrual method of accounting?

A. In my opinion it was.

Q. Were any adjustments made in the books or was there anything in the books to show that any adjustments were made for stock on hand, stock piles on hand, at the end of the year, or unfinished work?

A. I did not find any, but according to the Commissioner's—According to the Code and regulations, that does not appear to be necessary.

Q. I am not asking about the regulations, what the regulations [369] provide. I say: Is there anything on the books to show that?

A. I didn't find any.

Q. As to the books, if there was a million dollars in uncompleted work for which no billings had

(Testimony of Frank H. Eiseman.)

been made, that would not be clearly reflected income in the year in which the costs had been accrued, would it? A. Apparently not.

Q. Did you examine the books? You had the cash journal for 1938. What method of accounting is shown in the books for 1938?

A. What book are you referring to?

Q. What system of accounting do the books reflect was used in 1938?

A. My examination did not go into that very detailed, but there is some question in my mind whether there was any particular method, as here contended in this court, now, employed in the year 1938.

Q. I am not asking you to pass upon the testimony in this court. I am asking you, as an expert, to tell me what method of accounting was employed by this company in 1938.

A. I was just trying at the time to tell you my opinion about it. I understand that the contract for the State Capitol was kept on the percentage-of-completion basis, but I found a very important difference between the method described in the regulations and the methods employed in this particular year. If I may have a copy of the regulations and perhaps a copy of the returns, [370] I can explain.

Q. I didn't ask you about the regulations. I asked you if you could tell me what method of bookkeeping was employed, in your opinion, by the company for 1938. Can you answer that question Yes or No? Can you tell me?

(Testimony of Frank H. Eiseman.)

A. I don't think there was any particular method used in the year 1938.

Q. You don't think there was any particular method?

A. No. I found a combination of various methods.

Q. Weren't the books kept on an accrual method of accounting as they were in prior years?

A. The income and expenses evidently were accrued but the income—the income from the State Capitol job was not reported on any clear method as it is explained in the Code and regulations.

Q. On what method of—On what method was the long-term contract of the Capitol Building reported in 1938 and 1939?

A. As I mentioned before, it was not a clear-cut method according to the Code and regulations.

Q. Was it a percentage-of-completion method of reporting on that contract?

A. It was not a percentage-of-completion method as described in the Code and regulations.

Q. In what way, in your opinion, didn't it comply with the percentage-of-completion method?

A. The Code and regulations provide that on any uncompleted [371] contract which is to be reported on the percentage-of-completion basis, the percentage of completion should be applied to the income received, and then, from this income received, as computed, the actual expenses should be deducted. This was not done.

Q. Well, all right.

(Testimony of Frank H. Eiseman.)

Mr. Bischoff: Just a minute. I object to counsel interrupting the witness until he gets through with his answer.

The Court: Continue.

A. This was not done on the return. The income reported from the State Capitol job was not shown in this manner on the return for 1938. The manner in which it was done was that the total income received, according to the estimates, was taken and from it deducted the total expenses incurred up to date, plus the estimated expenses to complete the job, and this estimated profit then was multiplied by the percentage of completion, and this method is not in accordance with the Code and regulations for the year 1938.

Q. (Mr. Winter): Was that the method employed by the company prior to 1938 in reporting the Capitol job? A. I didn't check that.

Q. Then you say there was a hybrid method—there wasn't an accrual method but there was a hybrid method used in 1938 in reporting the income?

A. I believe you might call it that. I should say, further, there was another contract started in the year 1938 and, if the [372] taxpayer would have been on a clear percentage-of-completion basis, he would have had to report certain profit or loss on that particular contract, which he did not do. That indicates to me that he was not really on the percentage-of-completion basis, as the Commissioner described it in the regulations, for the year 1938.

(Testimony of Frank H. Eiseman.)

Q. For the year 1939—Will you refer to the taxpayer's return? What does "percentage of completion" mean on the 1939 return? What does that mean, in your opinion?

A. I don't see any percentage of completion in 1939.

Q. You see "portion of completion" under these contracts, the Capitol Building—

A. I think you are referring to the year 1938 that you want me to look at.

Q. No, I want you to look at 1939.

A. 1939 does not indicate—

Q. What contracts are shown there?

A. Balance of the State Capitol, University of Oregon Library, alterations to the Morgan Building, main barracks building, St. Vincent's Hospital alterations, alterations to the Arlington Club, repairs to Multnomah Civic Stadium.

Q. Doesn't that balance refer to the percentage of completion that was not reported in the previous year on the Capitol Building?

A. The income tax return for the year 1939 does not indicate [373] anything about that.

Q. What does it say as to the Capitol Building?

A. May I read it to you?

Q. Yes.

A. State Capitol Building, Job 193—

Q. Yes.

A. —final contract price, \$2,072,012.58.

Q. Yes.

A. Cost: Labor, \$176,003.94; materials, subcontracts, insurance, et cetera, \$1,778,091.02, and then \$112,406.52; a total cost of \$2,060,556.48, and this,

(Testimony of Frank H. Eiseman.)

deducted from the contract price, leaves a profit of \$5,457.10. There is no mention made of percentage of completion.

Q. That is the balance or percentage of the building was completed in that year, isn't that right? A. That is my understanding.

Q. In other words, that is the percentage of completion, the final completion of the building, and about 90 per cent had been reported in prior years on a percentage-of-completion basis?

A. The tax return for 1939 does not indicate anything about percentage of completion. I think the figures you mentioned are on earlier returns.

Q. When you compare that return with the 1938 return, it shows the final percentages of completion?

A. If I may say so, it means the same thing, approximately. It [374] is the balance of the profit which had not been reported in prior years.

Q. On a percentage basis?

A. On whatever basis they had been using. If it was a percentage basis, yes, but I don't think it was a percentage basis, in agreement with the Code and regulations.

Q. Refer to the next contract.

A. You want me to read that?

Q. Yes.

A. University of Oregon Medical School Library, Job 194.

Q. Yes.

A. Contract price, \$332,642.16, less cost of labor, \$61,399.21, materials, subcontracts, insurance,

(Testimony of Frank H. Eiseman.)

et cetera, \$242,625.03, total cost \$304,124.84. This, deducted from the contract price, leaves a profit of \$28,517.32.

Q. Read the next one.

A. Alterations to Morgan Building, Job 195: Fixed fee, \$1,726.61, less \$850.85 which, deducted from the fixed fee, leaves two thousand—pardon me. May I correct that? Added to the fixed fee gives a profit of \$2,577.46.

Q. What was the amount of the fixed fee?

A. \$1,726.61.

Q. Read the next one.

A. Main barracks building, Job 196. Portion of contract completed—— [375]

Q. Read that again, “Portion of contract completed.”

A. Portion of contract completed,—Let me finish.

Q. I want you to read that wording again.

A. “Portion of contract completed in 1939,” as per War Department certificate, \$752,082.54, less cost of labor \$179,868.56, materials, subcontracts and insurance, et cetera, \$545,089.52, total cost \$724,958.08, leaves a profit of \$27,124.46.

Q. In other words, in reporting the income from that contract for 1939, the taxpayer kept the books on an accrual basis, you say, is that right?

A. That is my opinion.

Q. Then, he reports on the portion of the building completed as per——

A. ——per the certificate.

(Testimony of Frank H. Eiseman.)

Q. In other words, he is reporting his profit on the percentage of the completion of the building, isn't that right?

A. I don't think that is necessarily the same.

Q. What?

A. I don't think that is necessarily the same.

Q. That is not necessarily the same?

A. No.

Q. But he kept reporting it on that basis?

A. My understanding is that it is not the same in many cases.

Q. It is not the same in many cases?

A. No. [376]

Q. You are familiar with the fact that many taxpayers report their long-term contracts on a percentage-of-completion basis and keep their books on an accrual basis?

A. They accrue items of expense and accrue income, but that does not mean that they are on the accrual basis for the purpose of reporting long-term contracts.

Q. What do you contend or understand is the difference between the accrual and percentage-of-completion basis, if any?

A. It is the substance of this whole discussion. On a percentage-of-completion basis, one of the conditions is that we have to take inventories into account. On the accrual method for construction contracts, the Commissioner does not require any inventories, and there are other conditions which may come up under certain circumstances, but I

(Testimony of Frank H. Eiseman.)

think that is one of the basic differences between the two methods.

Q. In other words, you think the Commissioner only requires the use of inventories with respect to mercantile goods where the taxpayer is keeping his books on the accrual method of accounting?

A. Mercantile and manufacturing companies.

Q. You say that is the only time the Commissioner may require a taxpayer to keep an inventory at the end of the year and make an adjustment for the work completed for which no billing has been made?

A. In a general way, yes. There may be a few more types of [377] business that we have not mentioned here, and which I might be able to think of, but generally you are right on that.

Q. If, for example, a taxpayer keeps his books on a strict accrual method of accounting, that is, he has accrued all his work, labor and materials, and he did not make any billings for three months prior to the end of the year, and, therefore, did not accrue any income, do you think such a method of accounting would clearly reflect the income?

A. If he had the right to receive this money, then he should have accrued it on the books. "Accrue" means to show it on the books, show income on the books when he has the right to receive it, when the right to receive it is established—the right to receive and the amount to be received is established.

Q. Suppose, for some reason, under the contract the engineer refused to approve an estimate,

(Testimony of Frank H. Eiseman.)

although the work has actually been completed, and it is not approved until the end of the year. Would you say that would not result in a distortion of income for income tax purposes?

A. No doubt it would be in the taxpayer's interest to get approval if there is justification for it, and he would fight for it as much as he could. Assuming an engineer would not, for certain reasons, give him a certificate, because the workmanship was faulty, there evidently cannot be any accrual.

Q. If the taxpayer wanted to shift his income into a subsequent year and could properly not seek getting a certificate, he could [378] then just fail to get a certificate approved and thereby put the income over into the subsequent year. You say if the taxpayer were so inclined he could do that?

A. Theoretically, it might be the case but here, in this particular case, Mr. Hammond indicated that he needed all the money he could possibly get to finance his contract, and he put his billings in just as soon as he possibly could.

Q. Mr. Eiseman, I didn't say Mr. Hammond did it. I said, supposing a contractor kept his books on a strict accrual method, and only accrued these amounts for which he billed, without taking into consideration the work and labor performed on unfinished portions for which he could not bill, if he just failed to get a certificate and failed to bill them until after the end of the year, he could then effectively shift his income into the next year, isn't that right?

(Testimony of Frank H. Eiseman.)

A. If he had a right to receive the money, if he had a right to receive the certificate of the architect, he should have accrued it. If he failed to obtain a certificate, that in itself does not mean that he should have accrued it.

Q. I am not talking about whether he should or should not have. I say, he could then shift his income or substantial income into the succeeding year, if he were so inclined?

Mr. Bischoff: We have no charge of fraud or evasion, your Honor, or even a suggestion of it in the Revenue Agent's report, that any item was shifted from one place to another for the [379] purpose of evading tax. Why should we be trying that issue here?

The Court: Go ahead, Mr. Eiseman.

(Question read.)

A. Since he had the right to receive the certificate of the architect, it would be an accrual item. Just the fact that he had not asked for the certificate in itself would not mean that it should be accrued.

Mr. Winter: Q. Supposing a taxpayer made a constant practice of not accruing any items unless he had actually billed—

The Court: We will recess until one-thirty.

(Thereupon a recess was taken until 1:30 o'clock p.m.)

(Testimony of Frank H. Eiseman.)

Court reconvened at 1:30 o'clock p.m., Thursday, January 15, 1948.

Cross-Examination—(Continued)

By Mr. Winter:

Q. Mr. Eiseman, at the time of recess we were discussing what you considered the distinction between an accrual method of accounting and the percentage-of-completion basis.

Under the accrual method of accounting, where a taxpayer is reporting on long-term contracts, is it proper to accrue the value of the work in progress at the end of each year for which no billing has been made, but where all the expenses in performing that work in progress had been accrued? [380]

A. May I clarify something first in my mind before I answer that? Do I understand that you said "Under the accrual method"?

Q. No, I will reframe the question.

A. You are talking only about percentage of completion?

Q. I am talking about the accrual method.

A. Talking about the accrual method?

Q. Supposing a taxpayer keeps his books upon the accrual basis of accounting, on that method of accounting, where he is reporting on the accrual method, long-term contracts, is it proper to accrue on the books the value of the work in progress at the end of the year for which no billing has been made to the owner, but concerning which work considerable costs and expenses have been incurred and accrued on the books?

(Testimony of Frank H. Eiseman.)

A. If he was not entitled to receive any money over and above what he had billed, and he consistently followed that method, I think that would have been the proper thing to do.

Q. In other words, you think a proper method of accrual would be if he had expended one million dollars, for example, in completing work which lacked probably 2 per cent more to complete before he could make a billing, and he then billed after the end of the year, you say it would be a proper method of accounting not to accrue the value, regardless of whether he could bill it under his contract or not?

A. I think, as a matter of fact, contracts are never written—at least, I never, in my practice, have run across a contract of [381] this type, that billing has to be withheld until the final completion of the building. The contracts I have seen in my practice always have been on such a basis that billings could be made before the contract was completed, if there was a contract.

Of course, if the contractor goes ahead and locates a building on somebody else's ground without having any contract, that is a different story. What can happen, especially if this contract is with the Government—it could happen he never will be reimbursed for it; it could happen that the person who told him to go ahead would be removed from the position he occupied and none of his verbal commitments would be binding upon the Federal Government. It would be very questionable whether he ever could collect on this particular contract.

(Testimony of Frank H. Eiseman.)

But, providing there is a contract, according to the contracts I am familiar with, there is always a possibility to bill some portions of the money expended before the contract is finally—before the building is finally completed.

Q. All right. Supposing that the contract provided that he would be able to bill the owner based upon the material which was put into a building, plus the labor which was actually put in the building, on completion of one unit, for example, that cost one million dollars, but the contract provided that until the unit was completed he could not bill the owner—he could not bill the owner until that one unit of the contract was completed, and he had spent one million dollars in 1942, but it was [382] not completed to the extent that it could be billed until 1943. Would it or would it not be proper to the accrual method of accounting to accrue the reasonable value of the labor and materials that had been expended in 1942, the actual value?

A. I am not familiar with any type of contract—

Q. I say, if those were the facts.

A. Assuming that there would be a contract of that type—

Q. Yes.

A. —we would have a very similar situation to where the contract could be on a completed-contract basis. We have there also, maybe two or three years before the final completion of the contract, certain profits that might have been made being deferred to the very end, to the final completion of the contract.

(Testimony of Frank H. Eiseman.)

It may be somewhat contrary to logical thinking, but if the contractor continuously follows that method, I think it reflects, over the years, the proper income.

In the same way here, if the contractor continuously follows one method, to deviate from that particular method certainly would be the wrong thing to do. I think consistency is one of the important things in accounting.

Q. In 1938 the taxpayer in this case reported his income on the Capitol Building on the basis of the percentage of the completion of the total contract, didn't he?

A. Not in accordance with the Commissioner's rule.

Q. I say, that is what he reported, isn't it, on the basis of [383] percentage of completion?

A. Some method of percentage of completion but not the method prescribed by the Commissioner.

Q. I didn't ask you whether it was the method prescribed by the Commissioner, but the taxpayer, did he not, in his books and records and on his return, reported his income on the Capitol Building on the basis of percentage of completion of the total contract? Answer that yes or no, did he or did he not? A. Yes.

Q. He also reported the percentage of completion of the total contract in his return for 1939, didn't he, on the Capitol Building?

A. He reported the balance of the unreported profit.

(Testimony of Frank H. Eiseman.)

Q. That was the balance of the percentage of the total contract, wasn't it? A. Yes.

Q. He had already reported 98 per cent of the percentage of the contract in prior years, 1936, 1937 and 1938, hadn't he? A. That is correct.

Q. In 1939 he reported the balance of the percentage of the total contract, which was completed then, on his 1939 return? A. That is correct.

Q. And with respect to that other contract you were reading from, he reported the portion of the completed building on his return in 1939. That is what he says in his return, doesn't he? [384]

A. Not in those words. He reported that portion which he was entitled to bill. He showed that particular portion of the income which he was entitled to bill at that particular time.

Q. In 1939 the taxpayer reported the portion of the contract completed in 1939 on the United States War Department barracks?

Mr. Bischoff: He went over that, your Honor. He went over that matter and had the witness read off these items, and the witness was examined concerning them. I do not see any reason for a repetition of this matter.

Mr. Winter: Q. Were the estimates of the engineer based on the portion of the building that was completed?

A. I am not familiar with that particular contract.

Q. On any of the contracts were the estimates based upon the percentage of completion of the contract?

(Testimony of Frank H. Eiseman.)

A. Not necessarily. It depends upon the terms of the contract.

Q. Are you familiar with the terms of these contracts?

A. I have looked at some specifications of the Government contracts, general specifications of Government contracts.

Q. Under the Defense Plant Corporation contracts, he was entitled to reimbursement of 75 per cent of the amount of completed work, isn't that right?

A. I am not—

Q. To bill for?

A. I am not familiar with that particular contract.

Q. If he was only entitled to bill the owner for 75 per cent of [385] the amount completed in a year under the accrual system of accounting, wouldn't it be proper to accrue the value of the 25 per cent for which he could not bill, at the end of the taxable year?

A. That was a proper accrual method and, according to my investigation, that was done.

Q. Couldn't bill for the 25 per cent. The engineer could only allow them to bill for 75 per cent of the work which was completed, although he had to spend the cost of completing 100 per cent of it, isn't that right?

A. This particular 25 per cent was retained only.

Q. No, I am not talking about retained percentages, now.

Mr. Bischoff: Finish your answer, Mr. Eiseman.

(Testimony of Frank H. Eiseman.)

Mr. Winter: Q. I am not talking about retained percentages.

A. I don't understand your question then, very well.

Q. You understand, for instance, here is 10 per cent retained percentage on the contract; 10 per cent retained? A. Yes.

Q. There is also the 75 per cent that they will pay, based upon the engineer's estimate, isn't that right?

Mr. Bischoff: I object to the witness being interrogated about the contents of the contract. He did not purport to testify he was familiar with the provisions of the contracts. We don't even know whether Mr. Winter is correctly stating to him the import of the provisions with respect to payment.

The Court: If he doesn't know, he can just say so.

A. Yes; I am not familiar with this particular provision which you are mentioning.

Mr. Winter: All right.

Q. If the contract provides that 10 per cent of the contract price shall be retained by the owner and that the contractor is only entitled to bill the owner on the basis of 75 per cent of the amount of work completed on the contract, would it or would it not be proper to accrue the 25 per cent difference between the amount of completed work and the amount of the engineer's estimate?

Mr. Bischoff: Objected to, your Honor, as immaterial and on the ground that it is not the proper hypothesis involved in this case.

(Testimony of Frank H. Eiseman.)

Mr. Winter: The contract is in evidence.

The Court: What contract does that apply to?

Mr. Winter: That is the Defense Plant Corporation.

Mr. Bischoff: I prefer to have counsel read the provisions of the contract, so we will know what we are talking about.

A. I am not familiar with any provision of the type you mentioned here. I probably would have to study the contract first before being able to give you some opinion.

The Court: Which contract so provides?

Mr. Winter: The Defense Plant Corporation contract. The taxpayer is reimbursed 75 per cent of all materials located on [387] the site at the close of each month.

Mr. Bischoff: Where do you find in there that that is in addition to the 10 per cent retained percentage provision? Just read anything of that kind in there.

Mr. Winter: Article 15. "Payments: Unless otherwise provided in the contract, the owner shall make partial payments as the work progresses as follows: Upon appliaction by the contractor and certification by the architect-engineer, and approved by owner, owner shall make monthly payments to the contractor of 90 per cent of the value of labor and materials incorporated in the work and 75 per cent of all labor and material stored at the site up to the first day of the month as estimated by the architect-engineer, less the aggregate of all pre-

(Testimony of Frank H. Eiseman.)

vious payments, provided that the aggregate of all monthly payments shall not exceed 90 per cent of the contract price.

“Upon completion and acceptance by the owner of all work required hereunder, the amount due the contractor under this contract will be paid upon the issuance of the architect-engineer’s final certificate, after the contract shall have furnished the owner with a release of all claims against the owner arising under—” and so forth.

Mr. Bischoff: The 75 per cent refers to materials not incorporated.

Mr. Winter: That is what I said.

Mr. Bischoff: It was not included in your question. [388]

Mr. Winter: Ninety per cent where it is included in the building and 75 per cent where it is in stock piles.

Mr. Bischoff: That is what you say now.

Mr. Winter: Yes.

Mr. Bischoff: That is not what you said before.

Mr. Winter: Q. Wouldn’t it be proper to accrue the materials on hand—Don’t look at Mr. Bischoff. Look at me.

A. I am looking at you, Mr. Winter.

Q. Wouldn’t it be proper to accrue that percentage in accruals at the end of the year?

A. It all depends upon the method which had been followed in prior periods. The basic thing, in order to clearly reflect the income, is that the method is consistently followed over the years, and it is

(Testimony of Frank H. Eiseman.)

my understanding that this method has been followed in prior years to set up these retained percentages.

Q. Was it followed in 1938 and 1939?

A. I did not check any items in 1938 as to that regard. I would have to look at the books first to determine that question.

Q. Was a different method of accounting set up for 1939, 1940 and 1941 than was set up for 1938?

A. I think I have testified to that, what the accounting method was in the year 1938.

Q. Do you know what method of accounting was authorized for the year 1938?

A. I saw only the letter, the final letter of the Commissioner, [389] which was dated some time around May, 1938. I did not see the previous correspondence.

Q. Is it your understanding that a different method was employed in 1939, 1940 and 1941 than was employed in 1938? Is that your understanding?

A. I believe I testified to that before, that there was no clear method used in the year 1938.

Q. How were the books kept?

A. Accruals of income and accruals of expense were used in the year 1938.

Q. And the accrual method of income and expenses was used in 1939, too? A. Yes.

Q. The accrual method of income and expenses was also used in 1940?

A. Yes, but there is a difference in the way—Perhaps there is a difference in the way the contracts were reported. You refer to two different things.

(Testimony of Frank H. Eiseman.)

Q. You mean they made a change in the method of reporting on the contracts from what they had in 1938, is that what you mean?

A. We are talking about the difference between one job, the State Capitol job, and all following jobs. As I explained before, there was one contract started in 1938 which was not reported on the same basis as the Capitol job.

Q. How were the books kept in 1938? Was it on an accrual [390] method or was it on a percentage-of-completion method? The books, I mean.

Mr. Bischoff: Your Honor, I think at this time it would be appropriate for counsel for the defendants to now state their position with respect to the 1938 method as compared to the 1939 and subsequent years method, because the Revenue Agent's report denied us the right to use the accrual method in 1939 and subsequent years, because he says in 1938 he used the percentage-of-completion basis. Therefore, he says, we had to continue on that basis. That is what he says. Those are his words.

Now, he says, "You did not have a right to use any other but the percentage-of-completion basis, because you did not get consent."

From the examination that has been going on here ad infinitum upon this subject, it now appears that they want to take the position that 1938 was the accrual method the same as 1939. If that is their position, they ought to say so now so we will know where the examination is leading us to, so I may know whether I have to question him about that and your Honor will be able to know whether you are

(Testimony of Frank H. Eiseman.)

to go back to the existence or non-existence of a consent or the necessity for a consent to change the method. I think the case has gone far enough that they should take a position as to that.

Mr. Winter: Since the pre-trial and since the introduction in evidence of the letter requesting the Commissioner for a [392] determination of the method upon which they could keep books in 1938, counsel has made a right-about turn.

Mr. Bischoff: No, I didn't.

Mr. Winter: They introduced the 1938 income tax return, demanded everything from 1938 to 1944 in their subpoena duces tecum. He is now trying to eliminate 1938 and, while we might have made some mistake back there, we want to show that that same method was adopted, and that is that an accrual system of accounting was kept but not the true accrual and that they did not, in reporting the profit on contracts, adopt either a pure-bred accrual method or a pure-bred percentage-of-completion method.

Mr. Bischoff: What do you now claim the 1938 method was?

Mr. Winter: The method used by the taxpayer in 1938, just as he states in his letter.

Mr. Bischoff: What do you claim for it?

Mr. Winter: Just as the taxpayer said in his letter—I will read it.

Mr. Bischoff: We are entitled to have a statement of their position.

Mr. Winter: Yes. This is our position:

(Testimony of Frank H. Eiseman.)

“In accordance with the requirements of Article 42-4—” This is in March, March 3, 1938—” . . . application is hereby made for permission to account for profits upon contracts performed by this company upon a basis of percentage of the contracts [392] completed within each calendar year. Doubtless, this request is not necessary as no change is being made in the accounting method heretofore employed,” in view of the fact that the corporation’s books have been kept on an accrual basis and the individual books of Mr. Hammond kept on a similar basis.

If they had reported the true percentage of completion on their contracts, we would not be here, because there would not be this serious distortion of income.

That is what they asked the Commissioner to do and the Commissioner said “You can keep your accounts on an accrual basis”, and they have kept their accounts on an accrual basis, but they have not made any allowance for stock piles of material. If they accrue considerable in one year, a million dollars in one year, and they only accrue twenty-five thousand in another, it is just distorted income. There is no relationship, the way it has been reported, to the actual profit in any one year under any contract. In one year, if the Court please, as I pointed out, they had an \$8,000 income and no costs. Ridiculous.

Mr. Bischoff: May I read from the Revenue Agent’s report which is the basis upon which this adjustment was made?

(Testimony of Frank H. Eiseman.)

“In the taxpayer’s 1938 return the profits earned from the contract—” referring to the Capitol contract— “—were reported on the basis of percentage of completion. The computation was made in the return by estimating the total profit to be received from the contract, applying thereto the per cent of [393] completion, as determined by the engineers, (98.3), and deducting from the result the profit reported by the corporation. The estimated profit was determined by subtracting from the estimated total income from the contract the expenditures made to December 31, 1938, plus the estimated amount to be paid in 1939. The 1938 profit was computed in the same manner in the taxpayer’s books.”

That is his statement as to what we did, what our books show and what our returns show—percentage of completion.

Here is what he goes on to say: “For the years 1939, 1940, 1941, 1942 and 1943 the taxpayer made no attempt to keep the books or to prepare the returns upon the basis of percentage of completion.”

He goes on to point out that, because we had no consent, we had no right to depart from the percentage-of-completion basis which we used in 1938, despite this issue that he tenders and upon which they saddled us with a deficiency in tax.

Now, the examination is being directed to an attempt to establish that the 1938 bookkeeping method and return are not upon the percentage-of-completion basis. That is what they are trying to do now, and it is my view, since they have gone this far, they should take a position, so that we may know

(Testimony of Frank H. Eiseman.)

where we are going in this, whether we have got an issue about consent at all in this case, or whether there was any inconsistency.

Mr. Winter: Q. In good accounting practice, is it possible or is it desirable to keep books on an accrual method of accounting [394] and report the profit on contracts on a percentage-of-completion basis, long-term contracts? That is approved practice, isn't it? A. It is approved practice.

Q. It is approved practice to accrue income and expenses and to keep contracts on a percentage-of-completion basis. That is approved practice, isn't it?

A. Yes.

Q. And it clearly reflects income?

A. But that is separate. That is apart from an accrual method of reporting contracts on the accrual basis.

Q. I am talking about keeping the books on an accrual basis. In other words, a taxpayer can request to keep his books of account on an accrual basis and can also report the contracts upon a percentage-of-completion basis, isn't that right?

A. In the first part, having in mind to accrue income and expenses, then it is correct, yes.

Q. In the event you report the profit on contracts on a percentage-of-completion basis, whether it is a percentage based on the engineer's reports or whether it is a percentage basis based upon the per cent of the building completed, the completed building, based upon the engineer's reports, it is necessary to make allowance or make adjustments for

(Testimony of Frank H. Eiseman.)

stock piles on hand and uncompleted work at the end of the year?

A. On the uncompleted-contract basis, it is. [395]

Q. On a percentage-of-completion?

A. On a percentage-of-completion basis, yes, that is correct.

Q. It is absolutely necessary, in order that it won't distort the income from one year to another?

A. That is correct, but not on the accrual method of accounting; it is not necessary.

Q. How do you accrue contracts?

A. It is all based upon the right to receive a certain amount and the obligation to pay.

Q. Is there any consideration given to the type of contract upon which you could only be able to bill 75 per cent of the materials?

A. That would be a part—the difference between 75 and 100 per cent could be a part of that retained percentage we have been talking about.

Q. If it had been a part of the retained percentage, you will accrue that amount on your books?

A. Yes.

Q. Did they accrue anything on their books other than the billings based upon the engineer's estimates?

A. To my knowledge, the retained percentages have been added to income.

Q. Just the retained percentages, but did they accrue anything else?

A. I have not checked the other part. [396]

Q. There is no record of any inventory of amounts in stock piles?

(Testimony of Frank H. Eiseman.)

A. That is a part of the retained percentages you are talking about, the difference between 75 per cent received and 100 per cent which is shown originally on that particular billing. I would think that would be a part of that retained percentage, only the percentage is different from the percentage you have on the work done.

Q. What did they bill the Defense Plant Corporation on materials?

A. I am not familiar with that. I think you would have to ask the bookkeeper about that. I just made certain tests.

Q. As a matter of fact, they only billed 75 per cent of the materials to the Defense Plant Corporation, did they not?

A. I did not check that.

Q. No. Yet, how long were you down there?

A. I was down there about four—portions of four days.

Q. Portions of four days?

A. Yes, and the balance of the work I have done in the office, in my office.

Q. You say you went down there December 31st?

A. I didn't say I went down there. I started to work on that part of the case.

Q. And this other work you have done was up until last week?

A. Yes, the end of last week.

Q. You have been in court during all the testimony in this [397] case, with counsel?

A. Practically all of it, yes.

Q. Are you employed by Mr. Bischoff?

A. No, I have my own office. I am now practicing by myself.

(Testimony of Frank H. Eiseman.)

Q. Have you been doing any work for Mr. Bischoff?

A. This is the first contact I have ever had with Mr. Bischoff. In fact, I just met him when I opened my own office through his son, whom I know.

Q. Employed here on a fee basis or under subpoena? A. I am employed on a fee basis.

Q. Is that fee contingent upon the outcome of this trial?

A. No, not in any way; dependent upon the time involved in familiarizing myself with the records and the time spent in court.

Mr. Winter: I think that is all.

Redirect Examination

By Mr. Bischoff:

Q. State how much your compensation is to be.

A. I have not checked my time but—

Q. I mean, the rate of compensation that we agreed upon? A. It will be \$5 an hour.

Mr. Bischoff: That is all.

(Witness excused.)

[398]

ROBERT T. JACOB

was thereupon produced as a witness on behalf of plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Bischoff:

Q. Mr. Jacob, you are one of the attorneys in this case for plaintiff, are you not?

A. That is correct.

(Testimony of Robert T. Jacob.)

Q. Have you been attorney for the Ross B. Hammond Company for some time?

A. Since 1936.

Q. And up to and including the year 1942, what was the nature of the services you rendered for Mr. Hammond?

Mr. Winter: Objected to as incompetent, irrelevant and immaterial.

The Court: Answer.

A. I rendered various services in connection with his tax matters and with his business matters, too.

Q. Did he consult with you regarding his tax problems?

A. Yes, his accountants have with respect to the annual returns and they and he have consulted me about his business affairs.

Q. Did he confer with you at all prior to February 3, 1942, with respect to the formation of a partnership with his son?

A. Yes, he did. Either the latter part of 1940 or the first part of 1941, he consulted with me regarding a partnership with [399] Bill.

He said Bill was planning to go to Brazil to establish his own contracting business; he tried to impress upon him the fact that he was throwing away a good foundation, and that he would have to start at the bottom, which he felt was needless, and he said he had talked with him with a view to his coming in with him, and he wanted to be sure that he was tied in, so I discussed the matter with him generally, and he informed me Bill was to be married very shortly thereafter.

(Testimony of Robert T. Jacob.)

I asked him if he were aware of what the result would be if anything happened to Bill; that his wife would be the heir to his estate and so on and, after having pointed that out to him, he decided he would let the matter rest to see how Bill and his bride got along, so nothing was done then respecting the formation of the partnership.

Q. When was the matter broached again?

A. It was taken up again the early part of 1942, after Bill had returned from the time he spent at Fort Lewis.

Q. What precipitated the discussion at that time with respect to a partnership?

A. Well, he was trying to keep Bill from going into the service; he felt that because of Bill's training and his accomplishments and because of the fact that he—

Q. You don't need to go into detail, but was that the thing that brought the thing in focus again?

A. That is right, and the fact that he was entering into a number of other agreements with H. M. Mason and A. V. Petersen.

Q. What did he say to you as to his conclusion with respect to the formation of a partnership?

A. He decided he wanted the partnership formed.

Q. Did he give you any instructions with respect to preparing the agreement?

A. He did. He told me what interest Bill was to have; and what the drawing accounts were to be and instructed me to prepare the agreements.

Q. I show you Exhibits No. 2 and No. 3 and ask you if you prepared those instruments?

(Testimony of Robert T. Jacob.)

A. I did.

Q. Are those in the form they were originally, or has there been any substitution of any papers, as Mr. Winter has intimated in his examination here?

A. None whatsoever.

Mr. Winter: I object to that, as to my intimating. I asked questions. I can ask questions without counsel insulting me, I think. Of course, I consider the source.

Mr. Bischoff: After these documents were prepared, did you supervise the execution of them, or were you present, or did you just turn them for execution?

A. No, I sent them to Mr. Hammond in the mail.

Q. You retained copies for your files? [401]

A. That is right.

Q. In connection with the preparation of income tax returns for the Hammond Company, and members of it, did you undertake to make up the balance sheet and trial balance from which the income tax returns were made?

A. No, I didn't. The preparation of returns is made in two or three different ways—that is, the furnishing of advice or the actual preparation of the returns. In connection with Mr. Hammond, our office never has prepared any of the returns.

Q. Who actually accumulated the figures upon which the income of the taxpayer had to be determined, or from which it had to be determined?

A. Mr. Hammond's accountant in every case accumulated the information.

(Testimony of Robert T. Jacob.)

Q. To what extent did you have anything to do with the supervision of the income tax returns?

A. I was available for counsel and conferences as to any item under discussion, as to how it should be handled, and I checked the computations and, as a matter of fact, either I or my office checked the computations in each of the years in question, except possibly the year 1942. We have no record of having had anything to do with the 1942 returns. You will notice in all cases except the returns for 1942 where I assisted, I signed the returns.

Q. Is there any law or regulation requiring certifications if somebody else prepared the return?

A. The one who prepares the return is required to certify that he did so.

Q. Did you certify the 1942 return? I hand you this document.

A. I hold the return of Ross B. Hammond for 1942, and I did not certify to it.

Q. Will you say whether you had anything to do with the preparation of the return?

A. I did not.

Q. Did you have any consultation with anyone connected with the Hammond organization with respect to its preparation?

A. Not the final; I had nothing—I had never seen this final return until I came into the courtroom. As a matter of fact, I was not in the city at the time the return was prepared.

Q. Where were you at the time?

A. I was in Washington, D. C.

(Testimony of Robert T. Jacob.)

Q. When was the first time— Let me ask you this: Was there any understanding had at the time the partnership was formed as to whether it should be made public or not?

A. It was definitely understood that it was not to be made public.

Q. Do you know what, if anything, was done in connection with keeping of the accounts so as to reflect the partnership in the year 1942?

A. I made no—I did not give the bookkeeper any instructions at all about the accounting, and I made no examination of the [403] accounts, since I did not prepare the return for 1942.

Q. Did you have anything to do with the preparation of the amended 1942 returns for Hammond, individually, and the partnership?

A. I did, yes.

Q. I show you these documents and ask you if you prepared or assisted in the preparation of the 1942 amended returns and the 1943 returns?

A. I assisted in the preparation of the 1943 return of Ross B. Hammond, the 1943 return of Ross B. Hammond Company, the partnership return, and also—Well, this is 1944. Oh, yes. 1943; 1943 partnership return of Ross B. Hammond Company.

Q. What we have been referring to are the 1942 amended returns. Were those made in connection with or jointly with the 1943 returns?

A. Yes.

Mr. Winter: The 1942 amended return of Ross B. Hammond?

Mr. Bischoff: Yes.

(Testimony of Robert T. Jacob.)

Mr. Winter: There is no amended return of Mr. Ross B. Hammond for 1942.

Mr. Bischoff: Q. Mr. Jacob, will you explain how the amendment was accomplished and why it was done in that way?

A. As far as the return of Ross B. Hammond is concerned, personally, the 1943 return embodies the income of 1942. The two years were taken together to accomplish the forgiveness or to put [404] into effect the forgiveness provision of the Internal Revenue Act, so one return embodied the computation of the tax for both years.

Q. Was that the prescribed method of determining the application of the forgiveness tax?

A. That is right.

Q. The taxpayer had to recompute 1942 in connection with 1943?

A. That is right.

Mr. Winter: The taxpayer corporation did not.

Mr. Bischoff: The taxpayer to whom the forgiveness tax applied?

A. Right.

Q. In making these combined 1942 and 1943 returns, did you have occasion to examine the first 1942 return that had been filed?

A. I did.

Q. What, if anything, did you discover with respect to the partnership aspect of the organization?

A. I discovered that the partnership had not been taken into account.

Q. What did you do in connection with the matter?

A. Well, we prepared an amended return for William Hammond and we prepared the 1942 part-

(Testimony of Robert T. Jacob.)

nership return to reflect the actual operation, and I also instructed the bookkeeper to reverse an entry that she had made previously whereby she had credited William A. Hammond with a percentage of profit which was erroneously [405] determined. The computation compares exactly with the compensation paid to Petersen, but we made no change in the amount because the 25 per cent of the profits which was accruable to William after the deduction of the percentage of profits paid to Petersen and Mason, came within a very few dollars of the amount which had already been credited to him, so we made no change in the accounts in that connection. It seems to me the difference in computation was between twenty and thirty dollars.

Q. When you became aware of what had happened, did you discuss the matter with Mr. Hammond? A. Immediately, I told him about it.

Q. What was done or what did he instruct you to do with respect to it?

A. He instructed me to correct the record; that is, to put the partnership into effect as of the date it was organized.

Mr. Bischoff: You may cross-examine.

Cross-Examination

By Mr. Winter:

Q. Was there any reason for Mr. Hammond to sell a 25 per cent interest to his son, other than the fact that the percentage which had already been deducted, percentage of profits, came within a few dollars? Did that have anything to do with the 75-25 deal?

(Testimony of Robert T. Jacob.)

A. No, not at all. That was the percentage agreed upon at the time the agreement was executed. [406]

Q. When did you say the agreement was executed?

A. I say it was executed—that is, it was prepared prior to February 3rd.

Q. But you don't know when it was executed?

A. I didn't say the date.

Q. You were not present? A. No.

Q. You don't know whether it was executed until the following year, 1943, do you?

A. No, I don't, but—

Q. Was it prepared in your office?

A. Yes, sir.

Q. And the power of attorney was prepared in your office?

A. I don't believe it was. I am not sure, but I don't think the power of attorney was.

Q. Did you know the power of attorney had been given until I showed it to you here in the courtroom?

A. Oh, yes, I had a copy of it and I gave a copy to Mr. Williams, but I recall very distinctly with respect to that that Mr. Hammond, at the time the agreements were sent to him, called me and said it would be necessary to have a power of attorney under the conditions and, so, it was prepared and I don't know—I don't recall whether it was in my office or not; I rather think it was.

Q. Do you know whether or not, under a Government contract, they [407] can charge the reasonable expenses of a superintendent where one of the super-

(Testimony of Robert T. Jacob.)

intendents acts—where one of the partners, I mean, acts as a superintendent, on a cost-plus contract?

Mr. Bischoff: I object, your Honor. It has no relation to anything developed on direct examination.

A. I don't know.

Mr. Bischoff: Just a minute.

The Court: He has answered he does not know.

Mr. Winter: Q. Contracts 210 and 211, you are familiar with them? There was deducted from those contracts the salary paid Mr. Bill Hammond, plus the percentage of profits as accrued on the books.

Mr. Bischoff: Objected to as improper cross-examination.

The Court: What is the point, Mr. Winter?

Mr. Winter: The point I was trying to bring out is that there were other advantages. He now claims a partnership existed. Of course, it is our position for income tax purposes that there was no advantage and that Mr. Hammond received a salary, having been raised from \$4,000 to \$7,500 for his services.

The Court: That might be proper cross-examination of the principals but not of the lawyer, it seems to me.

Mr. Winter: Q. Did you advise Mr. Hammond that it would be to his tax advantage, or to his advantage, that Bill Hammond be working on a percentage of profits rather than as a partner?

A. No, sir, I didn't. [408]

Q. Of course, you didn't tell anybody about the formation of the partnership, did you?

(Testimony of Robert T. Jacob.)

A. Certainly not.

Mr. Winter: That is all.

Redirect Examination

By Mr. Bischoff:

Q. You told the stenographer to whom you dictated, I presume?

Mr. Winter: I don't know. The Notary Public couldn't find out. She took an acknowledgment.

The Court: Step down.

(Witness excused.)

Mr. Bischoff: The plaintiff rests, Your Honor.

(Plaintiff rests.) [409]

DEFENDANT'S MOTION FOR DISMISSAL

Mr. Winter: At this time, Your Honor, we move to dismiss the complaint on the ground that the plaintiff has failed to show his gross income or the credits to which he would be entitled to; in other words, has failed to show he has overpaid his tax during the year in question.

The Court: Decision is reserved until the end of the case. [410]

DEFENDANT'S TESTIMONY

W. G. WILLIAMS

was thereupon produced as a witness on behalf of defendant and, being first duly sworn, was examined as testified as follows:

Direct Examination

By Mr. Winter:

Q. Just state your full name?

A. W. G. Williams.

Q. Where do you reside?

A. Portland, Oregon.

Q. What is your occupation, Mr. Williams?

A. United States Internal Revenue Agent.

Q. And your post of duty is what?

A. Is at Portland, Oregon; Seattle Division, stationed at Portland.

Q. Under whom do you work?

A. S. R. Stockton, Internal Revenue Agent in Charge, stationed at Seattle.

Q. How long have you been a Revenue Agent, Mr. Williams.

A. Continuously since February 18, 1922.

Q. Since 1922? A. Yes, sir.

Q. Therefore, over a period of approximately twenty-six years? A. Approximately.

Q. During that time have you or have you not had occasion to [411] investigate tax liability of many, many taxpayers? A. Yes, sir.

Q. And particularly large taxpayers, is that right? A. Quite a number, yes.

(Testimony of W. G. Williams.)

Q. Were you called upon to make an investigation as to the 1943 tax liability of Ross B. Hammond? A. I was.

Q. When was that?

A. That was some time early in 1944. I first turned my attention to the examination in the latter part of July, 1944.

Q. Your report appears to have been dated——

A. —in the latter part of August, I believe.

Q. What?

A. The latter part of August, I believe.

Q. August 29, 1944. Was that about when you completed your investigation? A. Yes.

Q. Will you state whether or not you made a record of the total full days in time that you put in upon the investigation of the plaintiff's tax liability for that period? A. I did.

Q. How long did you spend in actual days and over what period of time?

A. Twenty-three days over the period, slightly more than a month.

Q. Slightly more than what? [412]

A. Slightly more than a month.

Q. Would you just tell the Court what you did in connection with the investigation? In other words, tell the court what you did with respect to examining the records and books?

A. I examined the general ledger, the journal, some of the billings, most of the contracts, most parts of the contracts, and any vouchers that were necessary to examine in substantiation of journal entries.

(Testimony of W. G. Williams.)

Q. In your report you state: "The lack of proper accrual accounting resulted in a distortion of profits as between the years included in the period of construction." What do you mean by that, Mr. Williams?

Mr. Bischoff: Objected to, Your Honor. It speaks for itself.

The Court: He may answer. Let him interpret his report.

A. The principal——

Mr. Bischoff: Page 5, Your Honor.

A. The principal error I noted in the accrual of the accounts——

Mr. Winter: I didn't get it.

A. The principal error noted in the accrual of the accounts placed on the books and as used to compute the contractual profit on various contracts was in the omission of the use of inventories—work in process and inventories of stock piles on hand at December 31st of 1942 and 1943, for which income had not as yet been reported for that particular period. [413]

Q. On what basis were the books apparently kept?

A. The accounts were apparently entered on the accrual basis, as far as liabilities were concerned.

Q. Yes.

A. I considered that the income was not entered on a true and complete accrual basis for the reason that some of the billings were entered in

(Testimony of W. G. Williams.)

the early part of December of either one of the years and no income had been entered into the books for the period from the date of the billing to the end of the year. All the facts had happened which would establish the accrual of income, inasmuch as the billing had progressed—and on which the billings were computed—even though the amounts might not have been determined exactly until some subsequent period.

Q. Were you able to find on the books any record of the value of the work in progress for which no billings had been made at the end of the year? A. No, sir.

Q. Either the years 1941, 1942, 1943 or 1944?

A. No, sir.

Q. Were there any records of stock-piled materials on hand which had been accrued on the books and for which no billings had been made?

A. No, sir.

Q. In other words, it was impossible for you—Was it or was it not impossible for you to determine the true profit on a contract [414] on a percentage-of-completion basis? A. No, sir.

Q. Completion basis or percentage-of-completion basis of reporting on contracts?

A. No, sir.

Q. Was it or was it not possible for you to determine whether or not the profit income had been reported on an accrual basis?

A. Proper contractual income, you mean?

Q. Yes. A. It was not possible.

(Testimony of W. G. Williams.)

Q. Why do you say it was not possible?

A. Because I consider in accrual accounting—it is general accounting practice that in accrual accounting, where expenditures have been made for supplies, that only deductions be permitted for which income is reflected for that period; that the inventory of supplies on hand must modify the deduction.

Q. How was the income for 1938 reported? Was that reported on an accrual or percentage-of-completion basis of the contract, or how?

A. The income was determined in accordance with the percentage of completion of the contract, of the construction.

Q. How were the accounts kept?

A. The accounts were kept on the books on the accrual basis.

Q. The books were kept on an accrual basis?

A. The liabilities were entered on the accrual basis and the [415] income was entered on the billed basis.

Q. Were the accounts kept on the books from 1938 through 1944 on the same basis or not?

A. The accounts were placed in the books on the same basis.

Q. However, as I understand it, the only long-term contract that was in existence in 1938 and 1939 was reported on a percentage of the completed contract, on the basis of the percentage of the completed contract, is that right?

(Testimony of W. G. Williams.)

A. That is right. The percentage of completion of construction was used to determine the amount of income reported in 1938.

Q. Did that also happen in 1939 with respect to the balance, when the contract was completed?

A. That is right.

Q. Where on the books or the returns is the profit to Mr. Petersen and Mr. Mason and the profit as reported to Mr. William A. Hammond? Where is that reflected in the income tax returns?

A. For 1942?

Q. Yes.

A. That was reflected by Journal Entry 125 in the journal.

Q. Yes.

A. In other words, the profits of the three were charged to three different job accounts.

Q. You mean by that it was deducted in the cost of those contracts and thereby the profit was reduced in that proportion?

A. That is right. [416]

Q. And the only profit in that proportion reported on the return? A. That is right.

Q. In other words, did or did not the plaintiff deduct profit on his contracts for 1942 in the sum of \$86,635.88, covering the profits accrued to Mr. Petersen and Mr. Mason?

Mr. Bischoff: We renew our objection to that, Your Honor, that the Petersen and Mason transactions are not issues in this case any longer.

The Court: Admitted on the same basis as before.

(Testimony of W. G. Williams.)

A. I believe that is the figure.

Mr. Winter: Q. The sum of \$77,366.37 was also omitted but deducted as expenses in the return for 1943?

Mr. Bischoff: The same objection.

The Court: The same ruling.

A. That appears to be the figure, as I remember it.

Mr. Winter: \$77,366.37? A. Yes.

Mr. Winter: In order to save time—I am sure that those are the total amounts paid Petersen and Mason—Do you agree with me, Mr. Jacob?

Mr. Bischoff: I didn't get the figures you read off.

Mr. Winter: The books will show and, to save time, I am sure those are the figures.

Mr. Bischoff: Your amended answer sets forth the figures. [417]

Mr. Winter: Well, those are the amounts.

Q. Mr. Williams, upon the completion of your examination, did you or did you not conclude whether or not the taxpayer's books clearly reflected the income for the year 1943?

A. I did not. I determined that they did not clearly reflect the income.

Q. Upon what did you base that conclusion?

A. Principally on the basis that, regardless of whether the contract profit was reported on the accrual basis or the percentage-of-completion basis, the books did not show sufficient information to properly compute the contractual profit for any

(Testimony of W. G. Williams.)

one of the years included in the term of the contracts.

Q. What did you do in your report to rectify the situation? Before you answer that, I will strike it.

Just point out to the Court what you have stated in your report as distortion of income.

A. With respect to those contracts?

Q. Do you understand what I mean?

A. You mean that I should point out where I considered distortions to have occurred?

Q. Where were they evident from the contracts?

A. As has been previously pointed out, and as I have pointed out in my report, the Troutdale Aluminum Plant is the most serious offender in this respect.

The income received and recorded for 1941 was \$59,775.31 [418] and the profit per books recorded, \$23,544.42.

For 1942, income received and recorded was \$1,036,623.10. A net loss was recorded of \$20,786.73.

For 1943, the net income recorded was \$274,-431.59; net profit therefrom reported of \$93,936.62.

The profit was so disproportionate as to cause me to believe that such disproportion would not be caused by the difference in construction as between the years. Consequently, I looked further in the books and noticed—I noticed this distortion at the beginning of my examination. I immediately attempted to find out why such distortion existed. I soon found out there were no inventories taken into consideration.

(Testimony of W. G. Williams.)

Q. By "inventories", you mean stock piles at the end of the year?

A. Stock piles at the end of the year or work in process, or the 25 per cent for which they had not billed, and I considered that was sufficient in a contract of that size to cause considerable distortion.

Q. In any of the contracts, is there any relative percentage from one year to the other, as far as profit is concerned? I mean, do they follow a pattern or not?

The Court: Before he answer that, let him amplify the reference which he made to the 25 per cent.

A. When the taxpayer billed the owner for the amount of construction completed and for the amount of materials and supplies in stock piles, he billed for 100 per cent of the contract price [419] attributed to the construction and for 75 per cent of the contract price—75 per cent of the cost of materials in stock piles.

(Answer read.)

A. I could amplify that.

The Court: I wish you would.

A. I could amplify that by the statement that such 75 per cent and 25 per cent pertained to the contract entered into with the Defense Plant Corporation.

The Court: I don't follow you. I think you will have to give me some figures now in order for me to understand all of that. Let us take any month.

(Testimony of W. G. Williams.)

December is the month we have been talking about a lot. Let's take any month. Could you put that in figures, what you have just said?

A. Does Your Honor wish assumed figures?

The Court: Yes, round numbers.

A. We will assume that billings for the construction in progress, in accordance with the engineer's estimates——

The Court: Is this for some one month?

A. We will take December 31, 1942.

The Court: O. K.

A. Say \$200,000. That would be the billing for 100 per cent of the work performed on the contract since the last billing.

The Court: Since the preceding month, probably?

A. Yes, and the stock piles attached a cost, we will say, of [420] \$100,000.

The Court: The stock piles did what?

A. They had a cost attached to them for their purchase of \$100,000. The billing would be \$200,000 attached to the construction of the contract and \$75,000 attached to the stock piles. The owner, in making payment of this amount, would pay 90 per cent of the \$200,000.

The Court: The billing would be \$275,000 in total. Right?

A. Yes, sir. The owner, in making payment, would pay 90 per cent of the \$200,000 or \$180,000, and the \$75,000.

(Testimony of W. G. Williams.)

The Court: Now, wait a minute. 90 per cent of \$275,000 is how much? The owner would pay 90 per cent of the \$275,000?

A. 90 per cent of the \$200,000 would be \$180,000 paid on the construction.

The Court: Yes. What happens to this \$75,000?

A. That is paid to the taxpayer by the owner.

The Court: Is that included in the \$200,000?

A. No.

Mr. Bischoff: That is in addition.

A. That is in addition to the \$200,000.

The Court: The owner is to pay 90 per cent of the \$275,000?

A. 90 per cent of the \$200,000 plus the \$75,000.

The Court: The same thing. 90 per cent of \$275,000, isn't it?

Mr. Bischoff: No, the \$75,000 is paid in full.
[421]

The Court: Let him testify.

Mr. Bischoff: I beg your pardon.

The Court: I did not mean anything personal. Maybe it would be better for Mr. Williams to write it out on a piece of paper for me, what happened. We will take a few minutes recess.

(Recess.)

Mr. Winter: Q. I think I asked you whether or not you were able to take the books and set up a true percentage-of-completion method of reporting the income on these contracts.

The Court: Did you get a copy of that?

(Testimony of W. G. Williams.)

Mr. Bischoff: No.

Mr. Winter: Q. You said you were unable to do it because the books and records were not complete, that there was no record of unfinished work.

The Court: Take a copy off of that and send it back to me.

Mr. Bischoff: Very well.

Mr. Winter: Q. Since there was no inventory of stock piles or no record kept of the percentage of work which was completed but which was not billed. A. Yes.

Q. I will show you what has been marked for identification as a part of Exhibit 21. What does that appear to be, Mr. Williams?

A. Estimate of work in progress.

Q. On the Milwaukie job? On the Milwaukie Housing Project? A. That is right. [422]

Q. What period does it cover?

A. This estimate covers the period October 14, 1942, to February 1, 1943.

Q. Does it show what date it was mailed on?

A. There is a lead pencil notation "Mailed February 2."

Q. Is that what you had reference to when you said a good deal of the work or some of the work appeared to be done and the costs incurred in one year and no billing made on work at the end of the year until the succeeding year?

A. That is right.

Q. Did you spot-check through these billings to ascertain whether those things——

(Testimony of W. G. Williams.)

A. Correct. I spot-checked through some of them where there appeared to be discrepancies.

Mr. Bischoff: May we have this contract identified so we will know what we are talking about? Mr. Winter, what contract folder did you take that out of?

Mr. Winter: This is from the Milwaukie Housing Project. A. That is right.

Mr. Winter: Contract 207.

Q. Is that the contract which showed an income per the books of \$7,634.09 and only a cost of \$577, I think it is, during the year?

A. I believe it is.

Q. In other words, over \$7,100 income reported than in costs in [423] that year. What did you do with respect to any adjustment of income because of your investigation and the failure of the books to record these matters? What method of accounting did you set up to arrive at an adjustment?

A. I set up a method of accounting which was, to some extent, similar to that used in 1938. I took the percentage of the profit on the total contract to the total sales.

Mr. Winter: Just a minute. I have another copy, if the Court wants to follow the witness. He is going to testify from his report. It is much easier to see.

Q. Just explain what you did. Then I am going to ask you to go down through each contract and show what adjustments were made.

A. Milwaukie Housing Project, Contract 207. I listed first the net profit from the books and the

(Testimony of W. G. Williams.)

manner in which it was arrived at and as reported on the returns.

1941	\$ 7,725.91
1942	22,630.17
1943	7,058.97

A total net profit of\$37,415.05

Q. That is the total profit on the contract?

A. Yes, derived from total sales of \$289,200.76.

I made an adjustment in the case of this contract. Inasmuch as the total construction had been 100 per cent completed prior to the end of 1942, it was quite apparent that the [424] amount of \$7,634.09 should have been accrued as at the end of 1942.

Q. Why do you say it should have been accrued at the end of 1942?

A. I have a notation here "Accruing 1943 sales and costs at 12/31/42. Transfer of income to 1943." In other words, I arrived at amended sales as follows:

1941	\$ 36,547.78
1942	252,652.98

The total is the same as in the
other instance,\$289,200.76,
which was not changed.

Taking the percentage of the total profit to the total income, or \$37,415.05, divided by \$289,200.76, we have 12.937397 per cent of the total profit to the total sales.

(Testimony of W. G. Williams.)

Allocating total profit to the years in proportion to the yearly income, in order to eliminate the distortion, that percentage was applied to the total sales in 1941, or \$36,547.78, we arrive at an amended income for that year of \$4,728.33.

The same operation applied to 1942 resulted in \$32,686.72, and that comprises the total profit of \$37,415.05. The profit reported on the return for 1941, \$7,725.91; \$22,630.17 for 1942; and \$7,058.97 for 1943 resulted in a total profit, as before noted, giving rise to an increase of profit for 1944 of \$10,056.55, a decrease in profit for 1941 of \$2,997.58, and a [425] decreased profit in 1943 of \$7,058.97.

Q. If I understand you correctly, then, the taxpayer had 12 per cent profit, approximately 12 per cent profit on the contract?

A. That is right.

Q. In other words, then, you allocated 12 per cent profit on the amount of sales in each year?

A. In ratio to the sales for each year.

Q. The next contract is 208 and 208-A. I notice in your report you say that in the returns, the sales, costs and profits were combined and, therefore, you combined them in your report. Is that what you did?

A. "In the returns, the sales, costs and profits from Jobs 208 and 208-A were consolidated for the stated reason that the work performed for the same agency in both contracts and the labor and material costs were not properly allocated to each contract."

(Testimony of W. G. Williams.)

In other words, apparently there was a mix-up of supplies purchased for both contracts and not perhaps properly allocated to each contract and, consequently, both contracts were consolidated and handled as if they were one contract for the purpose of this report.

Q. We have been talking about Troutdale a great deal. What was the percentage of profit on that contract?

A. Approximately 10 per cent, 10.194192 per cent, or a total profit to total sales in that amount, and that was allocated to the years in accordance with the sales, in ratio to the sales, [426] in the same ratio to sales for each year.

Q. In your original report to which you are referring, did you make any adjustments for profits deducted on those contracts for the amounts accrued to Mr. Petersen and Mr. Mason or the son, William?

A. I made no change for the profits accrued to Mr. Mason or Mr. Petersen.

Q. Were you later requested by the Commissioner or anyone to make any explanation of the report in that regard?

A. I was. The Commissioner asked a recomputation of the contracts, based upon the elimination of the accruals due to Mr. Mason and Mr. Petersen.

Q. And you made a report to the Commissioner?

A. Then I recomputed the tax on that basis and forwarded my report to the Commissioner.

(Testimony of W. G. Williams.)

Q. Will you state to the Court what Exhibit 29 is?

A. As I recall, Exhibit 29 is a recomputation made for the Commissioner.

Q. Upon what basis?

A. Upon the basis of the elimination of the accruals to Mr. Mason and Mr. Petersen.

Q. And accepting your report with respect to the other adjustments?

A. That is right.

Q. The adjustments of which we are now speaking? [427]

A. That is right and by—Well, that is all.

Q. Referring to page 18 of your report, Job 209, was any change made in the profit reported on that contract and, if not, explain.

A. Job 209, Bonneville Control House. I have a note here: "The income costs and net profit from this contract were consolidated with the figures of Jobs 208 and 208-A and the consolidated figures reported as Job 208 in the 1942 return. While this contract was performed on the site of the Aluminum Plant contract, the contract was executed as a separate construction project from Job 208, and the profits therefrom are treated herein as separate and apart from those derived from Jobs 208 and 208-A."

Q. You were able to determine from the books the total income in one year, 1942, you say?

A. The income received and recorded was \$42,-858.14.

(Testimony of W. G. Williams.)

Q. And the profit reported was what?

A. The profit reported was \$6,408.60.

Q. Did you make any change?

A. I apparently made no change in that.

Q. You did, however, in your report, or did you not, eliminate from this report the accruals to W. A. Hammond?

A. I did, with the exception of the \$7,500 salary, so-called salary, which had been understood by the other members.

Q. What recommendation did you make in your report, to shorten the matter, as to whether or not the partnership did or did not exist for income purposes, for income tax purposes? [428]

A. I recommended in my report that, for income tax purposes, the partnership did not exist in fact.

Q. Exhibit 29, that computation, is based upon giving effect to the recognition of a partnership?

A. That gives effect to the recognition of a partnership.

Q. Of course, if a partnership is not recognized, that computation would have to be revised accordingly? A. Yes.

Mr. Winter: I might say to Your Honor that we did not ask that it be introduced in evidence. It was merely identified, because I wanted the computation to be before the Court so Your Honor can see what the effects would be.

Q. Mr. Williams, when did you first find out that a partnership existed or that it was claimed

(Testimony of W. G. Williams.)

that a partnership existed? I presume it was when you received the return? A. I don't recall.

Mr. Bischoff: Just a minute.

A. I don't recall whether I was assigned the partnership return or not, but I did see the amended return or, at least, I saw in the file the amended return of William A. Hammond.

Mr. Winter: Q. Yes.

A. And I found it out immediately upon commencing my examination.

Q. Was there anything in the books and records of this corporation or anything that was exhibited to you which would indicate the existence of a partnership during the years 1942 and 1943? [429]

A. Not in the records of the corporation.

Q. Did you inquire as to whether or not there was a capital account of Mr. William Hammond?

A. I did.

Q. What were you advised and by whom?

A. I was advised by Miss Novak that there was not a separate capital account for William A. Hammond.

Q. You were down there shortly prior to August 29, 1944? A. Yes, sir.

Mr. Winter: I think you may inquire.

Cross-Examination

By Mr. Bischoff:

Q. When you received instructions or were placed in charge of auditing of the 1943 return, was that with respect to the determination of the application of the forgiveness tax?

(Testimony of W. G. Williams.)

A. I don't recall, Mr. Bischoff. I was given the return to examine. I do not recall any particular reason why the examination was ordered.

Q. You had the 1943 return before you, didn't you? A. Yes, sir.

Q. And from that you saw it was, in effect, a combined return for the year 1942 and the year 1943, which involved the application and computation of the forgiveness feature of the Act?

A. That is right. [430]

Q. And you, in fact, gave effect to that in your computation, according to your determination of the income? A. Yes, sir.

Q. So you were concerned, were you not, with the application of that forgiveness feature, as it is called? A. Yes, sir.

Q. When you undertook the examination of the combined returns—Strike that, please.

As a matter of fact, all of the taxpayers who became applicable or who were affected by the Forgiveness Act, passed in 1943, had to recompute their 1942 returns in conjunction with their 1943 returns to make applicable the forgiveness feature? A. Yes, sir.

Q. Now, when you undertook this examination, of course, you were aware that the books and returns of the taxpayer had been audited at least six times prior thereto, with respect to the question of their method of accounting?

A. I don't recall how many times they had been audited.

(Testimony of W. G. Williams.)

Q. You knew that they had been re-audited a number of times? A. Yes, sir.

Q. You knew they had been re-audited twice for the year 1938, didn't you?

A. I did not.

Q. And two reports rendered?

A. I do not now recall how many times they had been audited. [431]

Q. Did you know that they had been or that they were re-audited for the year 1939 twice and two separate reports rendered?

A. I don't remember, sir. It is probably the fact.

Q. And you knew that the same thing happened as to the year 1940? A. It might have been.

Q. You knew that the return had been examined at least once for the year 1941, before you re-examined the 1941 return? A. Yes, sir.

Q. Didn't you have copies of all Revenue Agent's reports before you when you were making that examination? A. Yes, sir.

Q. You did have them, didn't you?

A. Yes, sir.

Q. As to those prior reports, including the one that was made for the year 1941, there was no challenge in any of them, was there, as to the proper method of accounting adopted by the taxpayer?

Mr. Winter: Objected to as incompetent, irrelevant and immaterial. I can't see the reason for it. The fact that they have been audited a hundred times would not make any difference. The question

(Testimony of W. G. Williams.)

is whether or not they properly reflected the income involved.

The Court: What is the point, Mr. Bischoff?

Mr. Bischoff: We claim that the approval of the method of accounting which is implied in the reports rendered, because of [432] the failure to challenge the method, either the right to adopt it or the accuracy with which it was maintained, and the granting of refunds in some years and assessing a deficiency in some instances, led us to believe that we had the right to establish a certain course of accounting by which to conduct our business and upon which to account to our associates on a profit-sharing basis, and upon which to determine our tax liability, and our whole system of accounting was influenced by that.

The Court: Mr. Bischoff, there is very little equity in tax law and certainly no estoppel, is there?

Mr. Bischoff: There is law to the effect—I can't state it to Your Honor now. There is law to the effect that the consistent use of an approved method of accounting operates as an estoppel, even as against the Government. I mean as to the system. It might not prevent examination of some particular items that were erroneously carried, one way or the other, but I am talking now about the method employed and the system employed. The whole setup of this accounting method was carried through with a certain theory, and we had a right to do it. The whole picture would have been changed,——

(Testimony of W. G. Williams.)

The Court: Your whole argument leads back to estoppel. The Government says your method of bookkeeping did not correctly and truly and properly reflect the income. It looks like a clear-cut issue to me, no matter how long you had done it or why you had done it. [433]

Mr. Bischoff: Then, Your Honor, assuming for the moment that the rule of estoppel applies as against the Government in tax matters as it does in any other relationship between parties, here is what the Government's course of conduct led to, to our disadvantage: We pursued a certain course and in pursuing that course there were years in which we paid income tax which would be more than we would pay, more than we would be obligated to pay if we had adopted some other method which they now say is correct. We go on in that form consistently, without regard to the consequences to ourselves, for or against us.

Then we come to a point when the Government, recognizing the terrific burden of taxation that everyone has been subjected to, in 1943 passed the Act granting relief to taxpayers to the extent of 75 per cent of one year's taxes between 1942 and 1943, whichever is low, and then, when they are faced with that situation and the taxpayer is about to receive the benefits of that Act, according to the system which they had approved all along, they now say "You are to be deprived of that because you should have used another method of accounting."

(Testimony of W. G. Williams.)

The Court: My present view is they can take that position, if they can establish the method of accounting adopted does not properly reflect the income.

Mr. Bischoff: If Your Honor is ruling on this question of estoppel——

The Court: I am not ruling now. I said that was my present [434] view. As you may understand, 50 per cent of our work probably deals with Government cases and I have heard it discussed more than ten years now. If there has been some development in that field, I would be very interested to hear it.

Mr. Bischoff: I presume Your Honor will want authority submitted in due time.

The Court: Oh, yes.

Mr. Bischoff: And we will attempt to support our version of this matter the best we can.

The Court: Yes.

Mr. Bischoff: Over and above that, Your Honor, there are cases in which the courts, without regard to the doctrine of estoppel, have given that fact high significance in determining the current opinion of the Commissioner with respect to the adaptability of the method is sound or not. To that extent, at least, after all, these reports, and the basis upon which they were made, are significant and relevant.

The Court: Yes, I can see that. If Mr. Williams comes along, after half a dozen other people have worked on the books, and he finds something wrong

(Testimony of W. G. Williams.)

with them that they did not find, that tends to weaken the value of it.

Mr. Bischoff: To that extent, at least, that is clearly relevant. Whether it operates as an estoppel, we will attempt to support our position by authorities.

Q. I was inquiring as to whether you were aware from those [435] reports which you say you had that the method of accounting had never been questioned in all these reports up to your first report for the tax year 1941?

A. As far as I recall, sir, I was aware of the fact, but they were confronted with the same problems that I was.

Q. I am talking now particularly about the method of accounting. Are you aware in any instance in any of these early reports where that method was questioned? A. No, sir.

Q. So, it is fair to say that whatever criticism there is of it originated with you?

Mr. Winter: If the Court please, we have not criticized the method of accounting. We are saying the method of accounting, with respect to long-term contracts, does not clearly reflect the income.

Your Honor was inquiring about whether or not there is any estoppel in there. I want to read from the statute and regulations: "The net income shall be computed upon the taxpayer's annual accounting period, in accordance with the method regularly employed in keeping the books of such taxpayer, but if no such method of accounting has

(Testimony of W. G. Williams.)

been employed or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as, in the opinion of the Commissioner, does clearly reflect the income."

That is the statute. No matter what method of accounting [436] was employed here—I mean, method of keeping the books—it does not make any difference. The burden is upon the plaintiff to show that the method of accounting did properly reflect income and not upon the Government to sustain the method which was used.

The Court: Proceed.

Mr. Bischoff: Q. Mr. Williams, when you made the examination of these books over at the office—I presume that is where it was, at the office of Ross B. Hammond Company? A. Yes, sir.

Q. You were given whatever records or information you asked for or that you thought necessary to make a complete examination, whatever you wanted?

A. Yes, with probably one exception. I asked for any records which might reflect the capital account of William A. Hammond and I was told that there was no such record.

I have noticed that you have a little book which I had not seen before this trial in which there is a drawing account and to which \$37,000 for 1942 is credited to William A. Hammond, which would constitute that account—regarded both as his drawing account and capital account. That is the only exception.

(Testimony of W. G. Williams.)

Q. That is the only exception? A. Yes.

Q. You were satisfied they were trying, in good faith, to cooperate with you in every way? [437]

A. Yes, as far as I could tell, they were ready to cooperate. If I would ask for a record, I eventually received the record.

Q. Mr. Williams, did you ask to see the partnership agreement when you were making the examination? A. Yes, sir.

Q. Was that exhibited to you?

A. Yes, sir.

Q. Did you ask to see the Mason and Petersen agreement? A. Yes.

Q. And were they exhibited to you?

A. Yes, sir.

Q. When you made the examination as complete as you wanted to, did you find in fact any errors that you concluded were made, according to your version of the transaction, with any design to evade any taxation?

Mr. Winter: Objected to as incimpetent, irrelevant and immaterial. The plaintiff is seeking recovery here. No one has said there has been any evasion. We have just said for tax purposes this so-called secret partnership should not be recognized?

The Court: He may answer.

A. I saw no attempt to fraudulently evade taxes, no.

Mr. Bischoff: Q. Whatever conclusion you came to, I take it, then, it was to the effect that

(Testimony of W. G. Williams.)

some errors were made in the accounting system or in the way it was being carried out? [438]

A. Yes, sir.

Q. On your direct examination I understood you to say, or to summarize, that the chief defect that you found in this method of accounting which they followed was the failure to keep what might be termed as work-in-progress accounts or inventory accounts? A. Yes, sir.

Q. Am I stating it fairly?

A. That is one of the chief defects that I noted.

Q. But in setting up an inventory account, that would presuppose that they did have an inventory of which an account should be kept, isn't that right? A. Yes.

Q. If the fact be that they had no inventory during any particular accounting period, of course, there would be no necessity for maintaining an account? A. That is right.

Q. You, of course, have in mind or did have in mind, in making the examination, the distinction between a mercantile establishment where sales and purchases were the profit-producing factor, in which inventories and work in progress are necessary elements, and a contractor's accounts. Did you have that distinction in mind when you made this examination, and made your report?

A. The question of inventories and work in process being kept by a mercantile establishment did not occur to me, Mr. Bischoff, [439] because I was working with a contractor who is, in a sense, a

(Testimony of W. G. Williams.)

manufacturer, a manufacturer of building construction.

Q. That is just what I want to come to, Mr. Williams. Were you not proceeding on the theory that there was no difference in accounting principles, at any rate for tax purposes, between a contractor putting up buildings and a merchant who is engaged in buying and selling merchandise? Is that about correct?

A. No difference in what way?

Q. I am just asking you what your reaction was.

The Court: That is not what he said. He said there was no difference between a contractor and a manufacturer.

Mr. Bischoff: Q. Let me restate the question. Perhaps I was not very clear in my question.

In making the examination, did you proceed on the assumption that the same accounting principles apply to a contractor as apply to a merchant engaged in buying and selling merchandise?

A. No, sir, I made no such assumption because the mercantile dealer did not occur to my mind.

Q. Did you go on the assumption that a man contracting to build a building is selling and buying materials?

A. I went on the assumption, sir, that a man contracting to build a building is handling his accounts—should handle his accounts in the same way that a manufacturer manufacturing some other article. In other words, it is a general accounting principle— [440]

(Testimony of W. G. Williams.)

Q. When you say "manufacturer ——"

Mr. Winter: Let him finish the answer.

A. It is a general accounting principle that when a taxpayer expends money for material and supplies that deduction for the cost of those materials and supplies is made in the year in which the income is attributed.

The Court: I will tell you what I don't understand, Mr. Williams. You use the expression "work in progress." A. Yes, Your Honor.

The Court: "Inventory" and "work in progress." They are different things, to start with, aren't they?

A. The term "Inventory," Your Honor, is loosely used in that manner.

The Court: "Work in process" or "work in progress" are the same thing, partially finished?

A. Yes.

The Court: "Inventory" is something that has been worked into the job—I mean, something that has not yet been worked into the job in any respect.

A. Yes. I was merely using the loosely-constructed term "inventory" as inventory or work in progress; in other words, summarizing, all the costs of the labor going into the work in progress and all the materials that have gone into the work in progress.

The Court: I don't want to get at it that way. I want to take "inventory" the same as these piles of sand and gravel we [441] see along the highway, to be used in the future some time. That is the in-

(Testimony of W. G. Williams.)

ventory I am thinking of. Work in progress, of course, is something that I can see, for instance, right across the street here, where these men are putting up some sheetmetal work. When they quit tonight, they are going to be partway through with what they are doing. They are going to have half of it or two-thirds of it, whatever the percentage is, completed. For the purpose of the question I am going to ask you, I am talking about "work in progress" in that way. Do you understand?

A. Yes.

The Court: Now, the system that these people used, that all was taken into account, wasn't it? In the system that they used, that was all taken into account?

A. It was taken into account up to the time that they were billed.

The Court: Up to the point where the engineers——

A. —made their estimate. Yes, from the time the engineers made their estimates. If it were December 15th, until the end of the year there would be a great deal of labor and materials and supplies gone into the work in progress which was not accounted for as at the end of the year.

The Court: You draw it that fine, do you?

A. Yes, because that amounts to a considerable figure, especially if the last billing were from one to two or three months old at the end of the year.
[442]

The Court: You are thinking about the fifteen days to the end of the year?

(Testimony of W. G. Williams.)

A. Yes, sir, or one.

Mr. Bischoff: Q. Now, Mr. Williams, when the engineer certifies that a certain type of work, that is, some particular item of work, had been completed to the point where it can be paid for, he deducts 10 per cent, we will say, for retained percentage. Did you treat that 10 per cent as work in progress that is unpaid for, or did you treat the whole of the work as certified as completed work?

A. The whole as completed work, and it was so treated by the taxpayer. A certain portion of it, 90 per cent, was received and accrued as income and 10 per cent was set up as retained percentage, and accrued to profit and loss in the taxpayer's books.

Q. The retention of a percentage, 10, 15 or 20, whatever it happens to be, is no indication that that particular work was not completed. It merely means the owner saw fit to retain some money as security out of some completed items. That is correct, isn't it? A. Yes, sir.

Q. If, in fact, there was at no time any work in progress in the true sense of the word, certainly there would be no need for maintaining an account for that purpose.

Mr. Winter: Objected to, Your Honor, that it assumes a fact [443] that has not been proven here.

Mr. Bischoff: A hypothetical question.

Mr. Winter: No records are here before the Court; no records were kept of work in progress or materials on hand. There isn't a single bit of

(Testimony of W. G. Williams.)

evidence, a single scintilla of evidence, and it is undisputed that no record was kept of it. We have no way of knowing what it was from the books and records.

Mr. Bischoff: Of course, if there was no work in progress at any time, there would be no occasion for keeping entries pertaining to it.

The Court: I don't take it that Mr. Williams claims to know whether there was or not.

Mr. Bischoff: I asked him hypothetically if there was; then we want to go to the next step to determine whether there were any such items that should have been recorded. We can only take this a step at a time, Your Honor.

Q. I will ask you again: If there were no work in progress in fact, there would be no need for setting up any account for that purpose, would there?

A. No, sir.

Q. Both with respect to inventories in the true sense, and work in progress. Did you make any effort to ascertain whether, at any given time, there was in fact any inventory that should have been recorded, any traditional inventory?

Mr. Winter: We submit, Your Honor, the questions answers [444] itself. He did not make an investigation until 1944, and clearly it seems to me it is argumentative.

The Court: How can he make a report based on the failure to keep inventories and an account of work in progress unless, in fact, there were inventories and work in progress? He can't just conclude there were.

(Testimony of W. G. Williams.)

Mr. Winter: It is self-evident from the billings they were being billed on a percentage of completion. As they completed a unit, they were entitled to bill for it, they became entitled to bill for that unit. It stands to reason that exactly at midnight December 31st there must have been a considerable amount of work in progress.

Mr. Bischoff: That is an assumption. Because a building is nearly two-thirds completed does not mean that they had a lot of materials on hand for the purpose of completing it.

The Court: Let's go ahead and try to get through. The question is: Do you know whether, in fact, there were inventories or work in progress?

A. I didn't know for a fact.

The Court: I will have to ask you one more question now. You did not try to set up what you think they should have done by way of inventories and work in progress, because you had no information available to you? A. No.

The Court: You just adopted your formula here by distributing [445] profits and distributing—What did you distribute? You distributed the income in the same proportion as expenses, wasn't that it?

Mr. Winter: No, he didn't.

A. Profits distributed in the same proportion—

The Court: —as income?

A. —as sales bore to the total.

The Court: The sales? Total sales?

(Testimony of W. G. Williams.)

A. Yes.

The Court: All right. Was that the formula you applied to correct the situation? The formula you applied grew largely out of the failure to handle inventories and work in progress?

A. I might state—I don't know whether it is relevant here or not.

The Court: Anything is relevant that you want to say, Mr. Williams.

A. But I have handled some millions of dollars worth of construction contracts during this period and in not one of them have I found a contractor who did not have work in progress or stock piles on hand. In fact, some contractors spent a great deal of money in creating large stock piles because stock was difficult to get, materials were difficult to secure, and they spent a great deal of time—one contractor had a number of men out continually looking for his materials and shipping them to the site of construction as fast as they could secure them. It [446] seems inconceivable that one contractor——

The Court: That is why we had allocations, to stop the race between people for materials, but there has been testimony here—you have heard it—that in some years of their operation these people did not have any substantial amount of inventory on hand at the end of any one year.

A. Yes, sir.

Mr. Bischoff: Q. In that connection, during the war years, a contractor performing Govern-

(Testimony of W. G. Williams.)

ment contracts had a right-of-way for materials for that purpose, didn't he?

A. That could be answered better by Mr. Hammond.

Q. You have told us you have a great deal of experience with contractors. Don't you know that to be a fact?

The Court: Had priority.

Mr. Bischoff: Q. Mr. Williams, whatever system you found there of books, whatever you denominate it, it is true, is it not, that it was consistently carried on in the same way from 1939 to 1944, inclusive? I am talking about the method.

A. It depends, sir, upon what we term the method employed. In connection with contracts in the earlier years, prior to 1941, you did not have the same problems that existed after 1941. The problems were much greater in these later years. You were dealing with a much greater amount of materials than in the earlier years.

Mr. Bischoff: Q. I am afraid you didn't understand my question [447]

The Court: I am going to interrupt you now. Where did you get this formula that you applied, the percentage of profit to income?

A. In the first place, it was applied by the taxpayer in his 1938 and 1939 returns.

Mr. Bischoff: Which we deny.

The Court: All right. That is the first step.

A. And it seems to be the only method in which profits could have been distributed evenly through-

(Testimony of W. G. Williams.)

out the period. No other method suggested itself because it would have been impossible to correct any discrepancies in accounting which were not represented by figures in the books.

The Court: Let us say Mr. Hammond made \$250,000 under a contract that was spread over twenty-five months. Let us say he made \$240,000—\$250,000 under a contract spread over an even two years. Do you understand? A. Yes.

The Court: Why didn't you just split it \$125,000 one year and \$125,000 in the other and make it come out even?

A. Because, sir, it depends entirely—in some years there were a million dollars receipts; in other years there were only, say forty-two thousand. Consequently, the income was allocated in accordance with the figures——

The Court: You wanted to find the proportion to income? [448]

A. Yes. In other words, distribute the expense more evenly in proportion to the income.

Mr. Bischoff: Q. Mr. Williams, what I was trying to find out, not in very great detail—I am talking about the method of accounting, these accounts that were set up, including the absence of an inventory or work-in-progress account. Wasn't that general system uniform or consistent from 1939 to 1944?

A. Yes, sir. The accounts were on the accrual basis, the income, and the liabilities were accrued on the books as at the end of the year.

(Testimony of W. G. Williams.)

Q. Throughout your testimony, in discussing these computations that you made, you talked of sales. Did you treat, for the purpose of your analysis, the performance of these contracts as sales?

A. It is immaterial what you term them.

Q. I just want to know whether you did treat them as sales?

A. In my report I think you will find that it is not treated as sales.

Q. In your testimony——

A. Treated as income.

Q. In your testimony you spoke of them as sales. Do you want to change your testimony now?

A. Well, if it suits the situation best. It is immaterial to me what you term it. It is income received from the contracts.

Q. It is not necessary to please me. I am trying to get the [449] facts. In testifying about these things, you referred to them as sales. I want to know if that is the sense in which you construe this operation?

A. No, sir, it is not strictly a sale. It is contractual income.

Q. Did you put them in the same category as a manufacturer of merchandise?

A. As far as the nature of his operation is concerned, he is manufacturing a building, manufacturing a road, manufacturing other things; he is constructing them.

Q. Did you apply to him the same principles of accounting as would be applied to a manufacturer manufacturing merchandise?

(Testimony of W. G. Williams.)

A. To the extent in such cases it is necessary to set up prepaid expenses, modifying deductions.

Q. In other words, you applied to him the formula that is provided for in Section 42.4(a) Regulation 111, didn't you?

I will read it to you so you will have it in mind: "Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such cases there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning [450] of the taxable period for use in connection with the work under the contract but not yet so applied." A. Yes.

Q. Is that the formula you applied to the taxpayer in this case? A. Yes.

Q. In other words, you applied a formula which the regulations limit to one keeping his accounts and reporting on a percentage-of-completion basis, didn't you?

A. No. The regulation doesn't limit it to that particular form of accounting.

Q. Is there anything in the regulation——

Mr. Winter: Let him finish.

A. —that states it is so limited?

Mr. Bischoff: Q. Will you point out anything in this section, Section 42.4(a) and 42.4(b) which

(Testimony of W. G. Williams.)

authorizes the application of this formula that I just read to a contractor on the accrual basis?

A. No, sir, there is nothing in these sections which have any mention of a contract reported on the accrual basis.

Q. That is what I want to get at.

A. There is nothing in there mentioning that.

Q. But, nevertheless, you applied to this taxpayer here the formula as outlined in this Section 42.4(a), didn't you? A. Yes.

Q. One other thing I want to ask you about.

The Court: How did he apply that formula?

Mr. Bischoff: He applied it by reason of the fact that he insisted here that we should have had inventories and work-in-progress accounts.

The Court: The formula he applied was the per cent of total profits to total income, isn't it? That is the formula he applied, isn't it?

Mr. Bischoff: But he did that by rejecting our method of accounting because, as he insists, we did not maintain two accounts——

The Court: All right, but we are not trying his reasons. We are trying what he did.

Mr. Bischoff: But he says our system should be thrown out.

The Court: We are not trying the reasons why he did that. We are trying what he did. What he did was to apply the percentage of total profits to total income.

Mr. Bischoff: The point I am making now is that we adopted a certain system. He says we had no right to adopt it.

(Testimony of W. G. Williams.)

The Court: That it did not reflect the income.

Mr. Bischoff: And it did not reflect the income because we did not use this formula that he says is applicable and, therefore, our system is thrown out the window and he creates a new one.

The Court: His reasons could be bad, like any other situation, but the result, nevertheless, would be the same. [452]

Mr. Bischoff: Under the Revenue Act we had the election to select any method of accounting that we desired, subject only to the limitation that the one we select clearly reflects the income. The Commissioner cannot impose upon us a system that he wants to select for us. Now he undertakes to throw out our system and substitute another, whatever it may be, and it must be for a valid, legal reason, so his reasons are important.

Q. Mr. Williams, in analyzing our accounting system, you determined and rejected it as the correct method, among other things, because it could not clearly reflect the income in a given year. That is correct, isn't it? A. Yes.

Q. If it be the law that the term as used several places in the statute "clearly reflect the income" relates to the period of times or years during which a particular contract is being performed, then your criticism of our system would not apply, would it?

Mr. Winter: We will object to that as argumentative, Your Honor. It is certainly assuming something that has not been established.

The Court: That is the whole basis of the argument. Answer, if you can, Mr. Williams.

(Testimony of W. G. Williams.)

A. If I saw a case in which income had been bandied around ten years, and without any thought as to how much income had to be reported in any one year, I would say that those returns were [453] prepared on an erroneous basis, that each year stands on its own feet, and that the income is to be considered consistent only by reason of allocating it to given periods, and not over a period of years.

It might happen you would have a period of ten years in a contract and, according to your theory, for the first five, six, seven or eight years of that contract, during high tax years, there would be but very little income and then in the tenth year, when the income tax would drop down, you would then be permitted to report all of your income that way. Or, we could perhaps substitute five years for ten. It is not logical.

The Court: Suppose the income tax had gone up each year?

A. That is why I substituted five years for ten. If it were done in the fifth year, in the middle of the period, the taxpayer could then report in that one year all the income, in that one year when the tax was down, and then, according to his own fancy, distribute it. It is not logical, Mr. Bischoff.

Mr. Bischoff: Q. Mr. Williams, in making these audits or examinations—I don't know what you call them, technically—as an agent of the Treasury Department or Internal Revenue Bureau, you do not examine these on a purely scientific accounting basis, for the purpose of applying

(Testimony of W. G. Williams.)

purely scientific accounting methods. You applied it to see whether it was in accordance with the requirements of the Internal Revenue Act?

A. Yes, sir. [454]

Q. In other words, the law influenced your appraisal of the situation? A. Yes.

The Court: Is this formula applied a true percentage-of-completion formula?

Mr. Bischoff: No, your Honor, it is on a completed-contract basis. I can demonstrate it to your Honor right now.

Mr. Winter: No, it is not on a completed-contract basis. The percentage-of-completion basis would be if they kept the accounts in the way prescribed. The percentage-of-completion basis requires the taxpayer, as I read to your Honor, to do certain things. "There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the materials and supplies on hand at the beginning of the taxable year for use in connection with the work under the contract but not yet so applied."

If they had a million dollars in material on hand that is going to be applied the next year, they cannot accrue that million dollars.

The Court: Do any of the contractors use this method you applied in making report of income tax?

A. Yes, they have done so, your Honor.

The Court: Of their own device?

A. Yes.

(Testimony of W. G. Williams.)

The Court: Percentage of profit to income?

A. They take the estimated portion of the total contract and the estimated profit in the total contract and apply to that estimated total profit the percentage of completion of the contract and get the amount which is reportable in that year.

The Court: You just dragged another element in there. You just answered me, percentage of completion; that is percentage of profit to income each year?

A. The income as reported in each year is based upon the percentage of the completion of the contract.

The Court: Then this formula, you say, is a percentage-of-completion formula?

A. I could raise the same question that has been raised before. I could say this, that the profit of a particular contract is reportable in the year in accordance with the percentage of completion of construction, which would place it in a little different category than naming a percentage-of-completion theory as defined in the regulations.

The Court: Percentage of completion and percentage of income are not the same thing?

A. No, sir, not necessarily. They arise the same way.

The Court: The income is what the engineer will allow you to bill for? A. Yes, sir.

The Court: Isn't it? A. Yes. [456]

The Court: You are saying that more income should have been shown in the books perhaps than the engineer would allow them to bill?

(Testimony of W. G. Williams.)

A. No, sir. I am using exactly the same income that the engineer has allowed to be billed.

The Court: You say that these people should have shown more income in certain years because they had inventories and work in progress, as you call it.

A. Net profit, your Honor.

The Court: What?

A. More net profit. I have not changed the income, your Honor, that they have reported in each year.

The Court: You say they should have shown \$100,000, at the end of a given year, in inventory—we will use round figures—on a certain job. They have either bought and paid for it or been billed for it and have to pay for it.

A. Yes.

The Court: And you say, further, that they have certain work in progress. Didn't you say that?

A. Yes, if it is work in progress. I maintain that deductions must be allowable in the years for which the income is reported.

The Court: We will say these people did get \$100,000 in sand and gravel; they don't buy their concrete, we will assume, from Readymix. They have got \$100,000 in sand and gravel out here in a pile and they pay for it and that shows as expense for [457] that year.

A. That is right.

The Court: That cuts the tax down.

A. Yes.

The Court: Because they have got \$100,000 invested there. Now, you say that they should have put that \$100,000 on the other side, too.

(Testimony of W. G. Williams.)

A. Yes, sir, I say that \$100,000, if it has not been used and if it has not been billed for, then that part of the \$100,000 worth of inventory modifies the deduction by that amount.

The Court: Would you show it as income?

A. I would show it as a reduction of expense.

The Court: Comes to the same thing.

A. Yes.

The Court: You call it modified, though.

A. Reduced, in other words.

The Court: Reduced? That is not a percentage-of-completion job?

A. No, sir, but I have applied the profit in accordance with the income reported in each year, and the income reported in each year has been established by means of taking the inventory on the job completed to that job.

The Court: I do not say you are not right in what you have done. That is what I have got to decide at the end of the case. But what I think you have done is: You found a very lop-sided [458] situation and you took a formula of your own to level it off. It does not seem to me, from what I have heard, that you took a percentage-of-completion formula to level it off.

A. No, sir.

The Court: You didn't, did you?

A. No, sir.

Q. (Mr. Bischoff): Mr. Williams, taking your analysis of these figures that you set up—the first contract, I assume, is illustrative of the rest of them. Is that a fair statement?

(Testimony of W. G. Williams.)

A. I was rattling my papers. I am sorry. I didn't hear.

Q. The formula you employed in Contract 207, the first one on this list—— A. Yes.

Q. ——is substantially the same as you applied to the others? A. It is, yes.

Q. Very well. In the first line we have "Income Per Books" for the three years, 1941, 1942 and 1943. These are our figures as to income that we reported, is that correct? A. That is correct.

Q. You have them in the amounts we reported in the various years and you also have a total for the three years, do you not? A. Yes.

Q. The next thing you noted here were the costs as we reported them, and you broke them down into labor and material, but the total is given for each year as they appear on our books and as [459] we reported them. That is correct?

A. Yes.

Q. Then we have a balanced account for the total of the three years? A. Yes.

Q. Now, then, you show also what the net profits were according to the books, the profits by year for those three years? A. Yes.

Q. And then you show the total of the profit for the three years? A. Yes, sir.

Q. For the purpose of your computation you adopted the figures that appeared on our books to arrive at the amount of income for each year, didn't you? A. Yes, sir.

Q. You adopted our figures of the profits as reported in each of those years on our books?

(Testimony of W. G. Williams.)

A. Yes, sir.

Q. Then you took the profit we reported, as we reported it, and you divided it into the income, as we reported it, and arrived at the percentage of profit which you ultimately used in your computation, didn't you? A. Yes.

Q. By that process you concluded that the profit in those years was 12.93 and some other figures?

A. Yes, sir.

Q. Then you took that ratio of profit and applied it to each year's income as we reported it, didn't you? A. Yes.

Q. That is the ultimate figure you arrived at here? A. Yes.

Q. For the purpose of computing your income?

A. Yes, with that small exception of \$7,000 plus.

Q. So, when you took the gross income as we reported it and arrived at the total amount in order to get the percentage, you applied the completed-contract method, didn't you? A. No.

Q. For that purpose? A. No.

Q. Didn't you take the total as it was ascertained at the completion of all those contracts in these three years and use that for the purpose of dividing by the total of all costs for those three years? Didn't you? A. That is right.

Q. Well, isn't that information that is ascertainable only upon completion of all work?

A. That is right.

Q. So, to that extent, at least,—

A. That is not—

(Testimony of W. G. Williams.)

Mr. Winter: Let him finish his answer. [461]

A. That is not a completed-contract basis. The completed-contract basis is where you report all the profits in one year, which I didn't do.

Q. (By Mr. Bischoff): You took the information available at the end of the contract in ascertaining how much profit there was, didn't you?

A. Yes.

Q. You took that for two purposes: To arrive at the ratio or percentage which would apply to that year and you took it for the purpose of determining the amount of income which would be applied in that year, by multiplying the income, as we reported it, by your ratio which you ascertained? A. Yes.

Q. Wasn't that combination the application of a hybrid principle, adopting a completed method for the purpose of arriving at the total cost, for the purpose of arriving at the total income and for the purpose of arriving at a total ratio of profit? Wasn't that, to that extent at least, a completed-contract basis?

A. Its allocation of the completed figures to the various years contained in the contract, yes.

Q. Of course, without waiting for the full three years to expire you could not have arrived at that formula? A. No, sir, not accurately.

Q. If you had done that, you would then take our income as we reported it and allow us to deduct only that fraction of it which [462] you compute by your other ratio? A. Yes, sir.

(Testimony of W. G. Williams.)

Q. And to that extent you were attempting to apply, in part at least, the percentage-of-completion basis, or percentage-of-income basis, which would be the more accurate?

A. It was determined that way, yes, sir.

Q. Let me read to you from a section of the Internal Revenue Act which deals with the completed contract basis, Section 42.4(b).

Mr. Winter: I think education is very enlightening but I object to reading from a statute to a witness. He is not a lawyer. That is a matter of law.

Mr. Bischoff: You used this in examining him.

Q. "Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted, there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion."

Of course, you had this regulation in mind in making your examination, didn't you?

A. I know about that regulation, yes, but it did not apply to this case. [463]

Q. Therefore, you couldn't apply the completed-contract method in this case, could you?

A. No, sir, I didn't.

(Testimony of W. G. Williams.)

Q. For the obvious reason that you would have to eliminate, in all intervening years, all items of income and all items of expense pertaining to the contract, reported for the years 1941, 1942 and 1943; you would have to forget about the expenses of the contract until you got to the completion, is that correct? A. That is correct.

Q. You would have to defer all items?

A. Yes.

Q. We did not attempt to do that here, did we?

A. No, sir.

Q. With all this in mind, will you please tell the Court which of the four methods of accounting which the regulations make optional or authorized, was used; that is to say, whether it was cash or accrual, percentage-of-completion or completed-contract basis? Which of these do you now claim was used by the taxpayer in maintaining his books?

A. I didn't use, strictly, either one of them.

Q. Could you——

Mr. Winter: Just let him answer.

Mr. Bischoff: All right.

A. I used the one which was described in Section 41 of the Act. [464]

Q. (Mr. Bischoff): I did not ask you what method you used. I asked you what method do you now claim the taxpayer used in maintaining his books and making his reports?

A. May I have a copy of my report, Mr. Winter.

Mr. Winter: Yes.

(Testimony of W. G. Williams.)

Mr. Bischoff: Can't you answer my question from your present knowledge of the case?

A. I will answer you what is in the record, sir. I stated "It would be extremely difficult at this time to place the taxpayer's accounts upon a true accrual basis or to determine the per cent of completion of the total of any contract at the close of any of the years under examination."

In other words, the taxpayer, I do not consider, used either a true accrual method, nor did he use a percentage-of-completion basis. The taxpayer, therefore, did not use strictly either one of the authorized bases.

Q. All right. Will you tell me now which of these four methods you used in making these computations?

Mr. Winter: Object to that question. He said he didn't use any.

Mr. Bischoff: I didn't ask you. I asked the witness.

Mr. Winter: He said he didn't use any of them.

The Court: Answer.

A. I used, strictly, neither one.

Q. (Mr. Bischoff): In other words, you used a hybrid method, [465] then, didn't you?

A. A hybrid method, sir, means a combination of any one of the two or the four. I used the method which is described in Section 41 which states that the Commissioner can set up a method which, in his opinion, best reports the income.

Q. Well, is it correct to say, then, that you ignored all the four methods which I have enumer-

(Testimony of W. G. Williams.)

ated and adopted a method of your own? Is that what you now want to say?

A. It might be said that way, yes, sir.

Q. Mr. Winter read to the Court an alleged contractual provision with regard to the method of payment in which there was a 10-per-cent retained-percentage provision and a 25-per-cent deduction for materials on hand. I want to ask you: From what contract was that taken? I want to identify the contract from which that provision was quoted?

A. It was taken from one of the contract blanks of the Defense Plant Corporation. That is simply a sample copy.

Mr. Bischoff: You had a sample copy of a contract that you thought was uniformly used and that is what you read from?

Mr. Winter: It is a printed form, a copy of Defense Plant Corporation form of contract. It is Form No. DPC58.

Q. (Mr. Bischoff): You did not read that from any contract that was entered into with the plaintiff in this case, did you? A. No.

Q. Do you know whether the plaintiff had any contract with any [466] agency or anybody, any transaction involved here, in which that method of payment was provided for in the contract?

A. I can only speak from recollection. It has been three and a half years since I made this examination and since I examined the contracts. It is my recollection that he entered into several of those contracts which provided that the stock piles shall be paid—I believe one of them was 95 per cent, 90 per cent, and others were of varying ratio.

(Testimony of W. G. Williams.)

Q. You made work sheets, didn't you, when you were making this examination? A. Yes, sir.

Q. Didn't you make notations of those instances in which there were 25-per-cent material deductions to be made?

A. I didn't go through and make details of all the contracts, no, sir.

Q. Are you prepared to say now that there is any contract in which there is a 25-per-cent provision such as was read from?

A. I am prepared to say it is my recollection there were.

Q. Do you know which ones they were?

Mr. Winter: The contracts are the best evidence.

Mr. Bischoff: You have represented to the Court here that all of the contracts were upon that basis.

Mr. Winter: There are enough.

Mr. Bischoff: I want to know where you got that. We deny that, your Honor. [467]

Mr. Winter: There are enough.

Mr. Bischoff: I am going, your Honor, to submit to your Honor a sample of every contract that is in evidence here, as to what the payment provisions are. We want to know why they refuse to tell the Court——

Mr. Winter: Have you got any more questions of the witness?

Mr. Bischoff: Yes, I have got lots of questions to ask him.

The Court: Does that have something to do with Mr. Williams' opening statement when I asked him to make me a memorandum?

(Testimony of W. G. Williams.)

Mr. Bischoff: Yes, your Honor, in that very connection. Of course, if that situation does not exist, the hypothesis we have been talking about is of no interest.

The Court: I was not clear at all how Mr. Williams applied that to the case.

Mr. Bischoff: I intend to question him about the application of that method here, your Honor.

The Court: You do not need to talk about it if the contracts do not have any such a provision. The sheet which he prepared and gave me showed payment in full for materials; showed 10 per cent retained for work in construction and showed payment in full—I made a misstatement. 75 per cent.

Mr. Bischoff: Yes.

The Court: What did he claim for that? What do you understand he claims?

Mr. Bischoff: I don't know yet what he claims for that, your [468] Honor. I am going to ask him a question to find out what significance that has as far as the accrual of income is concerned. That is what I intend to ask.

The Court: You don't need to, if you think they haven't any such a contract.

Mr. Bischoff: I want to make that statement to your Honor, however, for the present, qualifiedly. I want to be sure. I want to verify these contracts to be sure about that. We attempted to do that during the recess and we were unable to complete it. I am going to ask permission of the Court to take out of the courtroom these contracts for the purpose of making that examination.

(Testimony of W. G. Williams.)

The Court: Ask Mr. Williams about this little sheet he made up, a copy of which you have. I will give him this one. Ask him what he claims for that. I didn't get it.

Q. (Mr. Bischoff): Mr. Williams, under this hypothetical situation embodied in these figures that you gave to the Court, in which we assume a billing of \$200,000 and materials of \$100,000, we received actually 90 per cent of the \$200,000 which represents work completed, and 75 per cent of \$75,000 of the materials on hand. Is it your contention——

The Court: Ask him what his contention is.

Q. (Mr. Bischoff): What is the significance of that accounting method?

A. It is my recollection that 10 per cent retained in work under [469] construction was charged on the books and credited to profit and loss at the end of the year and \$200,000 was properly accrued on the books.

Q. To that extent, it was correctly carried on the books? A. Yes.

Q. With respect to the materials mentioned in the hypothetical question, of which there was \$100,000 on hand and only 75 per cent was allowable——

A. My contention is, sir, that \$75,000 of the \$100,000 in stock piles is covered by income reported under that particular billing but that 25 per cent, which was not covered, has been left dangling in the air. That is my recollection as to how the matter happened.

Q. Assuming that this \$100,000 worth of materials was on hand and they billed \$100,000 but

(Testimony of W. G. Williams.)

they paid \$75,000: What, according to your examination of the books, did the taxpayer do in a situation of that kind? Did the taxpayer accrue the 25 per cent additional, or didn't he?

A. My recollection is that they did not.

Q. You speak about recollection. Have you any papers or memoranda that will enable you to make a correct statement, that is, a definite statement?

A. I doubt if I have anything bearing on the 25 per cent, no sir. When I saw that the accruals were not correct, there was little use of my going further in making a detailed audit to secure such [470] details. It was up to me at that time to set up the accounts in a manner in which I thought they would report most consistently the income.

Q. Wouldn't it be necessary to ascertain whether such items of the 25-per cent retained were or were not entered on the books as accruals, in order to determine what was actually done?

A. I intended to make no adjustment for that, after having determined there were no inventories of stock piles taken between the billing and the end of the year. Consequently, there was no point in going further.

Q. Probably you did not understand my question. Would it not be necessary to ascertain, so you could tell the Court, whether such items of the 25-per cent retained were or were not entered upon the books as accruals in order to determine what was actually done?

The Court: In fairness to Mr. Williams, Mr. Williams was not working out a case for the Court

(Testimony of W. G. Williams.)

in which he was interested in any way. I don't think you need to question him any further. He said that is merely his recollection. He is illustrating that inventory item and he didn't carry it out any further. You have offered evidence here that the inventory item was of little importance in this man's operation.

Mr. Bischoff: Among the items there were three or four—three or four or a few anyhow—that you referred to I think by way of illustration and, among them, was this Milwaukie job. [471]

You said there was no record of inventories in connection with that. I call your attention, Mr. Williams, to the estimate on this very job by means of which this payment was made which is being criticized here. I call your attention to line 16,—

The Court: Bring it up to him.

Mr. Bischoff: —reading “Value of materials suitably stored at conclusion of this period, none.” There is a blank space there. Of course, there could not be any inventory of that kind maintained on the job, when there wasn't any.

The Court: Is that the engineer's estimate?

Mr. Bischoff: Yes.

Mr. Winter: What is the date of that estimate?

A. The date of that estimate was October 28, 1941, and the net amount due on work performed was only \$7,500. The net amount of work performed to date was \$289,000. Wait a minute. Is that in dollars? Yes. \$289,066.67, less amount of previous estimate, \$281,566.67.

(Testimony of W. G. Williams.)

Q. (Mr. Bischoff): The net amount of work performed to date, \$7,500, being to October 28, and on that estimate sheet it shows the work to have been 100 per cent completed.

Mr. Winter: Does that answer your question?

Mr. Bischoff: Well, it does not go to the question of inventory. What inventory should they have reported in that case, when there wasn't any? [472]

Mr. Winter: If the building were fully completed, there wouldn't be any.

A. If you will notice, there was no labor in that job. There was only a small amount of materials which were purchased. It seems to me that \$7,500, whatever it was, payment was held up. The job had been completed but apparently there was some little service to be performed and that payment was merely held up pending performance of that small service. That small service entailed only the purchase of some \$580 worth of material.

Q. (Mr. Bischoff): You regard that as a trifling item in relation to that total, don't you?

A. Yes.

Q. But if the contracting officer or the engineer refused to pay \$7,600 because he claimed that we had to do a certain amount of work, that contract is not complete?

A. I think you have misstated it. I think if you will look into this case you will probably find that they have not refused to pay it; they merely held up any acceptance until some small service had been completed in connection with the playgrounds.

(Testimony of W. G. Williams.)

Q. If they refused to approve the estimate, isn't that equivalent to a refusal to pay?

A. I am not saying that they have refused to approve the estimate.

Q. You don't know, but if that be the fact, would that indicate a completion of the work in that year?

A. Not necessarily. The thing is too hypothetical to assume [473] that fact. Unless you have all the facts, it is impossible to state.

Q. Mr. Williams, the sum and substance of this matter we have discussed, the last item, is that the question revolves itself around whether or not the percentage of money retained was accrued on the books? Is that the issue that you are trying to make?

A. Depends on the percentage you are talking about. 90 per cent, with 10 per cent retained, I will assume it belongs on the books properly.

Q. And accrued? A. Yes, sir.

Q. And taken into income? A. Yes.

Q. Now, the question that we still have undecided is whether the 25 per cent, if there are any instances of that amount retained out of materials on hand, was or was not accrued. Is that correct?

A. That is the question still undecided.

Q. What, in your judgment, should have been done? Should it have been accrued the same as the 10 per cent to make a proper accounting?

A. Yes, sir.

Q. It should have been accrued?

(Testimony of W. G. Williams.)

A. Not exactly in the same manner. The remaining 25 per cent [474] should have been applied as prepaid expenses.

Q. It would come to the same thing, whether you took it off one end or the other? A. Oh, yes.

Q. It comes to the same end? A. Yes.

Q. If it should develop any percentage, whether it be 5 per cent or 25 per cent, was retained from any unused materials or stockpiled material for which billing was made, and those items were accrued on the books, then there would be no criticism about this method of bookkeeping?

A. Oh, no. You are mistaken. There would be no criticism upon that particular point.

Q. That is what I am talking about. I didn't mean to enlarge it. A. Yes.

Q. I mean on that particular point.

Mr. Bischoff: Your Honor, may we recess, because I want to get these contracts so I can submit to your Honor the true situation here.

Mr. Winter: Can't we finish with this witness tonight?

Mr. Bischoff: I may want to ask some further questions.

Mr. Winter: What about the contracts?

Mr. Bischoff: I would like to ask your Honor for an adjournment at this time, with permission to take the contracts from the [475] courtroom.

The Court: All right.

Mr. Winter: How are we going to examine the contracts if you are going to take them from the courtroom?

(Testimony of W. G. Williams.)

(Thereupon, at 5:05 o'clock p.m., an adjournment was taken until 10:00 o'clock a.m., Friday, January 16, 1948.) [476]

Court reconvened at 10:00 o'clock a.m., Friday, January 16, 1948.

W. G. WILLIAMS,

having been previously duly sworn, resumed the stand and was further examined and testified as follows:

Cross-Examination—(Continued)

Mr. Bischoff: May it please the Court, after last night's adjournment, with permission of the Court, I took the contracts out with me and I have prepared a summary of the contract provisions with respect to the method of payment, with appropriate references to the page and paragraph numbers of the contracts in which they appear. I have had it typewritten and I would like to submit it to the Court as a matter of convenience in locating readily the particular provisions.

Mr. Winter: Does it cover all the contracts that were admitted in evidence?

Mr. Bischoff: It covers all the contracts referred to in the Revenue Agent's report.

Mr. Winter: Does the exhibit cover other contracts not in the Revenue Agent's report?

Mr. Bischoff: There is a group of contracts which I discover, in going over them, which are in no way connected with any of the matters in controversy here; they just happen to be in the bundle.

(Testimony of W. G. Williams.)

I made no attempt to summarize those contracts, and I am going to ask permission to withdraw those from the file later, but I did not attempt to summarize those.

I summarized every contract that appears in the Revenue Agent's report.

I may say in explanation as to one contract, Contract No. 207, the contract itself is in the file but the specifications are not in the file and we have not been able to locate them. They have been missing for a long time, before this case arose, even, and it is in the specifications that the provision regarding payment is contained, but there will be evidence introduced here that the provision in that specification, being a housing project, was the same as in 208 and 209. It was also a housing project and the provisions were identical, and I have so treated that in this summary.

Mr. Winter: What was that contract?

Mr. Bischoff: 207.

Mr. Winter: Mr. Williams can answer that question.

A. No, sir, that is the Milwaukie Housing.

Mr. Winter: Milwaukie Housing?

A. Yes.

Mr. Bischoff: I will say to your Honor now, in connection with the matter that precipitated this question yesterday was the absence or presence of this 10-per cent retained-percentage provision and 25-per cent retention for materials not incorporated. There are two such contracts in the group. The rest of the contracts, [478] with some slight varia-

(Testimony of W. G. Williams.)

tions, which I think are not important here, are 10-per cent retained-percentage contracts, using the express language materials incorporated and materials at the site. That is the language used in preparing the estimates, materials delivered on the site and preparatory work done may be taken into consideration. That is one type of contract. In another type of contract they merely use the words that the billing shall be for 90 per cent of the materials incorporated and stored. Those are the two types of 10-per cent retained-percentage contracts.

Mr. Winter: Do you have another copy of that that I might use? I want the witness to have a copy of it.

Mr. Bischoff: The evidence will develop here that in both of those contracts—I refer to 213 and 216—the entire amount was accrued on the books; that is, 100 per cent billing was accrued on the books and treated as income in the years; that is, 10 per cent of the value of materials stored on the ground was included in the buildings.

Mr. Winter: That is, the material on hand at the time of the engineer's estimate, not at the time of the billing. That is your contention?

Mr. Bischoff: I don't know as I quite understand. The billing was made in accordance with the terms of the contract and they made the distinction between materials incorporated in the work and materials stored on the site. [479]

Mr. Winter: At the time——

Mr. Bischoff: At the time of the billing.

(Testimony of W. G. Williams.)

Mr. Winter: At the time the engineer had to estimate it. I just want to know whether you are making any distinction, or whether you are contending that they made no inventory after the engineer's estimate at the end of the year.

Mr. Bischoff: No, I am not talking about inventory. I am talking——

Mr. Winter: Talking about materials?

Mr. Bischoff: Whether the billing was done; and when they billed for a given month they included not only the materials incorporated but they included the materials that were on the site and they accrued 100 per cent on the books although they were entitled to receive only 75 per cent at that time for the materials which had not yet been incorporated. I don't know how else I can state it.

Mr. Winter: Was that at the time the billing was made that it was computed or at the time the engineer's estimate was made?

Mr. Bischoff: I can't answer you on that. The witness on the stand will tell you what was done. I didn't do the bookkeeping, so I can't tell you.

Q. Mr. Williams, have you before you a copy of your Revenue Agent's report? A. Yes.

Q. Will you please turn to Job No. 213. That is the job started [480] in 1943. That job started in 1943, didn't it? A. Yes.

Q. There is nothing for 1942 reflected in that item? A. No, sir.

Q. There was nothing thrown into 1942 from that job, was there? A. No, sir.

(Testimony of W. G. Williams.)

Q. You made the examination in August, 1944; am I correct about that? A. Yes, sir.

Q. You reported for the years 1943 and 1944 for that job, didn't you?

A. Yes, I merely showed in 1944 what was allocable for that year up to that time.

Q. As a matter of fact, that contract was not completed in 1944, was it?

A. I don't recall that, sir.

Q. Will you take the ledger which you examined at that time. That is the ledger account you examined except for the fact that there were subsequent entries made? A. Yes, sir.

Q. That does show there were charges in that account made subsequent to the time of your examination, doesn't it? A. Yes.

Q. In very substantial amounts? [481]

A. Yes, sir.

Q. Will you please read off the charges that were made to that account after your examination?

A. August 31st, there was a reduction of the debits of \$412.92; October 31st, there was a charge to the account of \$66.69; November 17th, there was a charge of \$419.73; December 30th, there was a charge of \$10,533.37, and the other debit is debiting the profit.

Q. Can you tell from that account now, as it is set up, what the net profit on the job was?

A. Yes, \$17,000.29.

Q. There was another profit in the earlier year, was there?

A. At the end of the period?

(Testimony of W. G. Williams.)

Q. \$10,000-odd at the end of 1943?

A. \$10,159.76.

Q. In other words, the total profit shown on that account at the conclusion of the job was \$27,000 and some odd, wasn't it? A. Yes, sir.

Q. At any rate, you reported a total profit on that job of \$38,870.27, didn't you?

A. \$38,870.28.

Q. In other words, you reported in 1944, as of August, 1944, a total profit of \$30,870.28, when, at the conclusion of the contract, the total profit was \$27,000-odd?

A. At the conclusion of the contract, yes. [482]

Q. And you broke down your profit from that contract, \$38,870, and you allocated \$35,000 of that, \$35,448.48 of that, to the year 1943?

A. Yes, sir.

Q. So you reflected a profit in 1943 of almost \$35,500 when your total profit on the whole job was only \$27,000? A. Yes, sir.

Q. In addition to that you added an additional profit in 1944 of \$3,421.79?

Mr. Winter: Is that additional?

Mr. Bischoff: Yes.

A. Well, in order to complete the total profit computed of \$38,870.27.

Q. As a matter of fact, at the time you made the examination, you could not determine what the profit on that job would be upon completion, could you? A. Not necessarily, no, sir.

(Testimony of W. G. Williams.)

Q. This figure of \$38,870, which you entered as the total, does not purport to represent the total profit on the contract, does it?

A. Not exactly, no, sir.

Q. It only purports to represent your estimate of the profit as of August, 1944?

A. That is right, sir. There were no further credits to income; there were no further charges to labor; therefore, the \$10,533.35, [483] which makes up the debit, must have been completely materials.

Now, before we proceed from there, Mr. Bischoff, it seems to me we should determine what Journal Entry 305 states.

Mr. Winter: Do you want to see Journal Entry 305?

Mr. Bischoff: Just a minute.

Mr. Winter: I think that the witness wants to offer an explanation of his answer by the journal entry.

The Court: You people stop jangling.

Mr. Winter: Yes, your Honor.

The Court: I want to wind this up this morning. I want it conducted on a more orderly basis.

Q. (Mr. Bischoff): Mr. Williams, my question was directed to you as to the situation as of August, 1944. That is what this is presumed to be, is that right? A. Yes.

Q. I call your attention to a figure of \$1,100 for the year 1944 under the label or heading "Estimated Additional Equipment Rental, \$1,100." You inserted that figure, didn't you? A. Yes, sir.

Q. You did not find any figures like that on the books, did you?

(Testimony of W. G. Williams.)

A. No, sir, that is estimated.

Q. That is an estimate you made of your own for additional equipment rental? A. Yes, sir.

Q. To apply the formula to this contract that you applied in the [484] preceding contract, Mr. Williams, wouldn't you have to wait until 1945 or, at any rate, until the end of the year 1944 and make your computations then?

A. In the present light, yes. At that time I had no other recourse.

The Court: While it is fresh in Mr. Williams' mind, let him see the journal entry, 305.

Q. (Mr. Bischoff): If there are any books you want to refer to, to make any explanation, just go ahead. A. May I read this, your Honor?

The Court: Anything you want.

A. This is the journal entry: Debit Job 213, \$10,533.37; Debit 217, \$1,428.26; Job 221, Kaiser Warehouse, \$714.13; and Credit Office Salaries, \$17,500.

The Court: Do you want to make any comment on that?

A. Well, at the time I was examining that contract, there were no further charges to labor, and this entry shows material charges subsequent to that time. There were no further credits to income. I had no idea or way of anticipating that they would take office salaries to the tune of \$10,000 and charge to this account.

Mr. Winter: In this particular year, 1944?

A. In this particular year, 1944.

(Testimony of W. G. Williams.)

Q. (Mr. Bischoff): You say that they had no right to allocate to their jobs the overhead involved in office salaries? [485]

A. Mr. Bischoff, I am trying to explain.

Q. All you mean is that at the time you made the examination——

The Court: He didn't say that they had no right. He said he had no idea.

Mr. Bischoff: I see.

Q. But at any rate you do not question the propriety of entering or allocating a part of the office salaries to that job at the end of the year or during the year, do you?

A. I am making no question now, no, sir.

Q. You know, too, don't you, that allocation was made was in part the Mason and Petersen earnings on those jobs? A. Yes, sir.

The Court: Are you talking about the plural, "jobs"?

Mr. Bischoff: That job.

The Court: What job was that?

Mr. Bischoff: 213 is the particular one I was questioning him about.

The Court: What is the name of it?

Mr. Bischoff: That was the Columbia Steel Casting Plant, 213, but in the journal entry there were several others of the same type and he read off the titles.

The Court: How big a job was it?

Mr. Bischoff: \$410,000; that is, up to that point.

The Court: Well, about \$400,000?

(Testimony of W. G. Williams.)

Mr. Bischoff: Yes. [486]

Q. Some time during the year, at any rate before the end of the year, they had to allocate and enter on the books the proportionate share of that kind of work in order to reflect the true income from that contract?

A. Mr. Mason and Mr. Petersen were paid by an allocation of a certain percentage of profits. It was not necessary to allocate those profits to any particular contract, but to charge them to profit and loss, as far as Mr. Hammond was concerned. Therefore, there may be a question as to the propriety of entering an allocation of profit on any particular contract, instead of to all contracts.

Q. Mr. Williams, it might not be material so far as the net amount of earnings from the whole operation is concerned, but so far as Mason and Petersen are concerned, it would be necessary to have that allocation to determine the profit from a particular contract, would it not?

A. It would, if, in their participation, the agreement read that they were to be paid a certain proportion of profits resulting only from the contracts on which they worked.

Q. Whatever proportion would come from the source of the work is a proper item, however, to be charged against the profit on that particular job?

A. Not necessarily.

Q. To determine the profit from that contract?

A. Not necessarily. If they were to be allocated profits from [487] Mr. Hammond's contractual

(Testimony of W. G. Williams.)

business, then their allocation of profits is a charge to profit and loss and not to any particular contract.

The Court: What was the total work Mr. Hammond did as covered by these contracts?

Mr. Winter: In any year?

The Court: I don't want in any year, but how many million dollars altogether?

Mr. Bischoff: Several million dollars.

The Court: Somebody guess. Who knows what he did?

Mr. Bischoff: Fifteen to eighteen million dollars of contracts, your Honor, is the estimate made by Mr. Hammond.

Q. Mr. Williams, in light of the fact that the account of this Job 213 shows that the profit on that job, when completed, was \$27,000-odd, isn't it fair to say that your allocation of \$35,444 profit in the year 1943 is a distortion, to use the term employed by Mr. Winter?

A. It would be a distortion, if that were a proper charge of \$10,000, participation of profits in their contractual business.

Q. As a matter of fact, by the formula you applied to this particular contract, you would produce about the same kind of a result that you criticized in the earlier contract, when you compared the profit as we reported it to the income in those years?

A. I do not admit that, no, sir. [488]

Q. You would not admit that?

A. Not in view of the nature of this debit.

(Testimony of W. G. Williams.)

Q. Will you turn to Contract 214, Oregon Wood-working? A. Yes.

Q. Is it open before you now? A. Yes.

Q. You did not raise any question about that one, did you? A. No, sir.

Q. The only profit involved in that whole business was \$286.05? A. Yes.

Q. Taking Contracts 215, 216, 217 and 220, was not the same situation true in each of those four cases and in 213—that is, when you made the examination, those contracts had not been completed and other items were accrued later.

I want to avoid going over the figures on each one separately, and I would like you to examine those to see if you can state if the same general situation did not exist with respect to those subsequent contracts?

A. In Job 215 that is true, only to the amount of \$414.17 charged August 31st.

Q. Will you state what the profit is upon completion?

A. \$8,984.81, on December 30, 1944.

Q. As against \$5,769.33 which you reported as of the time of your examination?

Mr. Winter: Do you want a piece of paper, Mr. Williams? [489] A. If you please.

Mr. Bischoff: Mr. Williams, maybe I can simplify my question so it won't require so much computation. As of the period of time when you made the examination, you just reported a profit of \$5,769.33, isn't that correct? A. Yes, sir.

(Testimony of W. G. Williams.)

Q. And the final profit on that contract, as of the end of that year, was eight thousand and what? Will you read that figure off? A. \$8,984.81.

Q. Would you examine the next one, No. 216, and see if the same general situation did not exist?

A. Yes, sir.

Q. That is, your examination was made before the completion of the contract? A. Yes, sir.

Q. You reported on No. 216 a profit of \$1,122.81, didn't you, as of the time you made the examination? A. Yes.

Q. What do the books report as the ultimate profit?

A. December 31, 1944, the total profit was \$814.86.

Mr. Winter: How much is that?

A. \$814.86.

Mr. Bischoff: Your Honor, if counsel on the other side would consent, we would like to excuse Mr. Hammond from further [490] attendance here. He is obliged to attend a very important Directors' meeting, set for 11:00 o'clock and, if he is not going to be wanted, we would like permission to excuse him.

Mr. Winter: I don't know of anything I want him for.

Mr. Bischoff: May he be excused?

The Court: Yes.

Q. (Mr. Bischoff): If you will turn to Contract No. 217, that was uncompleted when you made the examination in August, 1944, wasn't it?

A. Yes, sir.

(Testimony of W. G. Williams.)

Q. You reported for that contract, as of the time of your examination, a profit of \$19,192.80, is that correct? A. Yes, sir.

Q. What was the final profit reflected upon the close of that contract? A. \$13,382.33.

Q. Will you refer to Contract 220? That contract was not completed at the time of your examination, was it? A. No, sir.

Q. You reported a profit of \$1,554.56 on that contract, as of the time of this examination?

A. Yes, sir.

Q. And what was the profit disclosed at the end of the operation? A. A loss of \$1,252.22.

Q. Now, then, Mr. Williams, in the light of these facts, you [491] could not and, of course, did not, determine your ratio of profit to be applied in those years based upon the total completion of the contracts, did you?

A. I based it upon the total completion of the contract up to the time I made my examination, and in each one of those cases it looked as if the contract were practically wiped out.

Q. And, for the purpose of making your computation, and arriving at a ratio, you adopted the figures of income that were recorded on the books of the company in those years?

A. Yes. There have been some erasures in this account. I don't know what figures were erased.

Q. Are you suggesting that they have been erased since you made the examination?

A. I am making no suggestion, sir, but merely making a statement.

(Testimony of W. G. Williams.)

Q. You called attention to that. You must have had something in mind.

A. I had in mind that they did not seem to be the figures in here that would result in the profit which I showed in my report. There were no entries in the books after July 31st, 1944, except December 30th, entry of a loss of \$1,252.22. If your Honor will permit, I will take my working papers and see what analysis I have of this.

Mr. Bischoff: Please do that.

Mr. Winter: Do you want to come down here to get them?

A. Your Honor, may I go over to the bench for a few moments? [492]

The Court: Yes.

Mr. Winter: May I be excused for about three minutes, your Honor, to make an important telephone call?

The Court: Yes. We will have to wait, Mr. Williams, until Mr. Winter returns.

(Short intermission.)

The Court: Are you ready to proceed?

Mr. Winter: Yes, thank you, your Honor.

The Court: Mr. Williams, are you ready to proceed?

A. Yes. The figures which I copied from the books on Contract 220 show a total income of \$14,842. The books show \$14,842, the same figure.

The amount of labor which I copied from the general ledger as having been expended on this contract was \$3,544.31. The same figure is shown in the ledger.

(Testimony of W. G. Williams.)

In this ledger there are three columns. The ledger account for materials amounts to \$9,005.65. The figure which I copied from the ledger at the time I made my examination for materials was \$9,743.13, a total cost of \$13,287.44 to be deducted from \$14,842, or a net profit of \$1,554.56.

The only entries made in this ledger since I made my examination, or the only entry, is a debit in the amount of \$1,252.22.

I can't understand the discrepancy, your Honor. There have been a number of charges in this account. When they were [493] made I don't know, but I do know it would be inconceivable I would copy figures from this account with those discrepancies. There is no chance there for transposition.

Q. (Mr. Bischoff): Are there any figures in that book, up to the time you examined the books, that are different now from what they were when you examined them? That is what I would like to know. You threw in a statement about erasures, and I think we ought to clarify that.

A. I have not examined the books—this is the first instance that was noticeable brought to my attention.

Q. You had your working papers and you took off these entries. Aren't you able to tell us now if there has been any change in the figures here?

A. It would take about two hours' work to sit down and attempt to reconcile my figures with the figures in the book. That is not a simple question of law. It is a question of accounting.

(Testimony of W. G. Williams.)

Q. Mr. Williams, do you want that ledger any further?

A. If I am to go through some of these other accounts, I do.

Q. I am about to inquire about another matter.

A. Very well, if you are through with this. It is not too big a material difference, as far as I am concerned, in the final result.

Q. Of course, it is fair to state, whatever that erasure was, it was not with any intent——

A. I am not assuming that. [494]

Q. ——to deceive anybody?

A. I am not assuming that to be the case.

Q. With respect to the other contracts, those contracts in which provision was made for the retention of 10 per cent of materials that had been incorporated into the work and the retention of 25 per cent of materials that were on hand and not incorporated, having in mind that type of contract, Mr. Williams—there appear to be two contracts of that type among those that are listed in your report, to-wit, Contract 213 and Contract 216.

Did I understand you to say that the 10-per cent retained percentages had been accrued on the books?

A. Yes, sir.

Q. At the conclusion of yesterday's examination, you did not know whether the 25-per cent retention of materials not incorporated had been accrued on the books, is that correct? I mean, last night when we were questioning you about it, you didn't know whether it had or not.

(Testimony of W. G. Williams.)

A. It was my recollection that they had not, but I was not decided.

Q. Will you please turn to the ledger and journal and see now whether you can tell the Court whether this 25 per cent for materials had been accrued on those two contracts.

Now, Mr. Williams, I may say that we have available the pages which may facilitate the examination. With the permission of the Court, I will have Miss Novak give you the pages [495] so it will facilitate looking at the accounts.

You have now examined the records for the purpose of ascertaining whether the 25-per cent retention on materials which were not incorporated had been accrued on the books, have you?

A. In those two contracts that I examined.

Q. With respect to No. 213 and No. 216?

A. 213 and 216.

Q. Will you tell the Court whether you found whether or not those 25-per cent retentions were accrued on the books?

A. I found the 25-per cent retention to have been properly accrued on the books.

Mr. Bischoff: That is all.

Redirect Examination

By Mr. Winter:

Q. Just one or two questions. I think you stated on direct examination that you had been a Revenue Agent for twenty years, approximately?

A. Since 1922.

(Testimony of W. G. Williams.)

Q. And I think you told me this is the first time you have been called as a witness in any case which you have investigated, is that right?

A. Yes, sir.

Q. Now, Mr. Williams, Mr. Bischoff went into Contracts 215, 216, 217 and 220 at great length. Calling your attention to Contract [496] 215, in your allocation you understated the profit in that contract to the extent of about \$3,000, did you not?

A. Yes, sir.

Q. In other words, \$3,000 more profit than you included in your return or report?

A. Yes, sir.

Q. The next one, \$3,000 difference in the Government's favor; the first one, in the taxpayer's favor?

A. The first contract, 215, was in the taxpayer's favor, and 216, as I recall, there it was in the Government's favor about \$2,000.

Q. Under the Forgiveness Tax Act, which return became the 1943 return?

A. As I recall, the 1942 return was the major return.

Q. That became the return for 1943?

A. Yes.

Q. With respect to the 1944 return, no attempt was made by you to audit that return in this report?

A. No.

Q. Will you state what status that return is in now, at the present time?

A. That I don't know. I haven't the 1944 return.

Q. You have not examined it?

(Testimony of W. G. Williams.)

A. It has not been assigned to me.

Mr. Winter: I think that is conceded by counsel. The 1944 [497] return has not been closed.

Mr. Bischoff: Yes.

Q. (Mr. Winter): In other words, if there were additional allocations in 1944, the 1944 return will properly reflect them, if kept on a proper basis? A. Yes.

Q. And this won't have any effect on it, will it?

A. I would have to add up the increases and decreases. Such adjustment, if made at the end of 1944, would affect 1943.

Q. They could be made deductions in 1944. That would work those out?

A. That would work those out, yes.

Mr. Winter: That is all.

Recross-Examination

By Mr. Bischoff:

Q. With respect to these contracts, No. 213 down to No. 220, I did not quite understand. You say that your determination, which you made in your report for the year 1943, doesn't affect the determination of the deficiency that was arrived at here.

A. I don't quite understand it myself. You mean my determination of the deficiency will not be affected by such changes as you noted?

Q. Is that your testimony?

A. No, sir, according to my computation of the allocation of profits, it would affect 1943 to a certain extent. [498]

(Testimony of W. G. Williams.)

Q. That is the reason you examined both 1943 and 1944, to determine what you are going to throw into 1943 or take out of 1943 for the purpose of getting your comparison between 1942 and 1943 to make applicable the 75-per cent reduction in tax. You had to do that, didn't you?

A. Yes; that would change the percentage in a certain amount. It would not be too material, however.

Mr. Bischoff: That is all.

Mr. Winter: That is all.

(Witness excused.)

Mr. Winter: With the understanding that all the Government's exhibits that have been marked for identification are received in evidence, the Government rests.

(Defendant rests.)

Mr. Bischoff: The plaintiff rests.

(Testimony closed.)

The Court: You will want to brief this case and I will want it briefed substantially.

Mr. Bischoff: I beg your pardon?

The Court: Particularly with a statement being the equivalent of a pre-trial order, showing what each party deems to be the issue. [499]

Mr. Winter: Does your Honor request a transcript?

The Court: No.

Mr. Winter: I was going to inquire from the Reporter whether we could get a transcript, leaving out Mr. Bischoff's speeches and possibly any speeches I have made.

The Court: Take it up with the Reporter.

Mr. Bischoff: And may I inquire as to the time for briefs?

The Court: Thirty, thirty and twenty. [500]

REPORTER'S CERTIFICATE

I, Ira G. Holcomb, a Court Reporter of the above-entitled Court, duly appointed and qualified, do hereby certify that on the 12th, 13th, 14th, 15th and 16th days of January, A.D. 1948, I reported in shorthand certain proceedings had upon the pre-trial and trial of the above-entitled cause, that I subsequently caused my said shorthand notes to be reduced to typewriting, and that the foregoing transcript, pages numbered 1 to 500, both inclusive, constitutes a full, true and accurate transcript of said proceedings, so taken by me in shorthand on said dates as aforesaid, and of the whole thereof.

Dated this 25th day of February, A.D. 1948.

/s/ IRA G. HOLCOMB,
Court Reporter.

[Endorsed]: Filed Mar. 6, 1948. [501]

PLAINTIFF'S EXHIBIT No. 1

Treasury Department
Washington

IT:E:6

LBV

July 7, 1938

Mr. Ross B. Hammond,
1214 Spalding Building,
Portland, Oregon.

Sir:

Reference is made to your letter dated May 9, 1938, submitting additional information in connection with your request for permission to change your method of reporting income from the cash to the accrual basis beginning with the taxable year ending December 31, 1938.

It is stated that at December 31, 1937, you had no accrual of income not received, no income received in advance of when earned, no expenses accrued but not paid, and no expenses prepaid.

It appears from the information submitted that there will be no duplicated or omitted items of income or deduction.

Predicated on the foregoing, permission is hereby granted you to change your method of reporting income from the cash to the accrual basis, beginning with the taxable year ending December 31, 1938.

A copy of this letter should be attached to your return for the taxable year ending December 31, 1938, as evidence of the authority given you to re-

port your net income on the accrual basis for Federal income tax purposes.

Respectfully,

MILTON E. CARTER,
Acting Commissioner.

[Endorsed]: Filed Oct. 25, 1948.

PLAINTIFF'S EXHIBIT No. 3
AGREEMENT AND ARTICLES OF
PARTNERSHIP

The following Agreement and Articles entered into on this 3rd day of February, 1942, by and between Ross B. Hammond and William A. Hammond, both of Portland, Multnomah County, Oregon;

Witnesseth:

That, Whereas, Ross B. Hammond has heretofore been conducting a general contracting business under the name and style of "Ross B. Hammond Co."; and

Whereas, William A. Hammond has directed his studies and education to the end that he might become associated with said company as a member of said firm; and

Whereas, some years ago the said William A. Hammond completed his education and qualified himself as an expert construction engineer, and has for some time been in the employ of the said Ross B. Hammond Co. in that capacity; and

Whereas, after serving a short time in the Armed Forces of the United States, the said William A. Hammond has now been rejected for said service, and

Whereas, the said Ross B. Hammond Co. is bidding upon many building projects and said company proposes to engage in extensive construction contracts in furtherance of the defense program of the United States of America; and

Whereas, the said Ross B. Hammond desires to be relieved of some of the duties and responsibilities of the management of said business, and desires to further develop the knowledge and experience of the said William A. Hammond in the construction field; and

Whereas, the said Ross B. Hammond has this day sold to the said William A. Hammond a one-fourth interest in the assets and business of the said Ross B. Hammond Co.,

Now, Therefore, It Is Mutually Understood and Agreed By and between the parties hereto that they do hereby form a partnership and that the following agreements shall constitute their

ARTICLES OF PARTNERSHIP

I.

Said parties above named agree to carry on **business under the name and style of Ross B. Hammond Co.**

II.

The partnership to which this agreement applies began on this the 3rd day of February, 1942, and

shall continue for the duration of the joint lives of the parties hereto, unless dissolved by action of the parties or otherwise.

III.

The enterprises, businesses, pursuits, and occupations in which the partnership proposes to engage are as follows:

To carry on within the State of Oregon and elsewhere a general contracting and engineering business for the construction, building, erection, repairing, razing, remodeling, enlarging, removing and leasing of buildings and structures, and otherwise engaging in any work upon buildings, roads, highways, manufacturing plants, bridges, piers, docks, mines, shafts, water works, railroads, railway structures and on iron, steel, wood, concrete, masonry and earth construction, and to extend and receive any contracts or assignments of contracts therefor, relating thereto or connected therewith and to manufacture and furnish the building materials and supplies connected therewith.

To purchase or otherwise acquire, own, mortgage, pledge, sell, assign and transfer or dispose of, to invest, trade, deal in and deal with goods, wares and merchandise and real and personal property of every class and description.

In general, to carry on any other business in connection with the foregoing that it may find it convenient, expedient or necessary in order to fully accomplish said objects and purposes, and to do

any and all of the things hereinabove set forth to the same extent as natural persons might or could do.

IV.

The principal office and place of business of the partnership shall be in the City of Portland, Multnomah County, Oregon, and/or at such other place or places as the partners shall hereafter determine.

V.

The capital of the said partnership shall consist of the assets formerly owned by Ross B. Hammond Co., together with such contributions to the capital as may hereafter be made to the partnership by the partners and all the income and profits arising from the employment of said assets in the business conducted hereunder and not paid to the partners in drawing or by disbursement of profits, and the interests of the respective partners hereto shall be as follows:

Ross B. Hammond.....	75%
William A. Hammond.....	25%

VI.

The partnership hereby assumes all the liabilities of the said Ross B. Hammond Co., including liabilities incurred by the said Ross B. Hammond in agreements entered into with Henry M. Mason and A. V. Petersen, covering employment of said parties upon a profit sharing basis; and the said William A. Hammond specifically agrees that his

share in the profits and the losses of the company shall be computed subject to the payments which shall accrue to the said Henry M. Mason and A. V. Petersen under the terms of said agreements.

It is further agreed by and between the parties hereto that the drawings of the partners from the business of the company will be limited as follows:

Ross B. Hammond. \$22,500 per annum

William A. Hammond. 7,500 per annum

and it is mutually understood and agreed that any earnings in any year in excess of said amounts totaling \$30,000.00 per year shall be permitted to remain in and as a part of the funds of the company to be used for working capital of the said Ross B. Hammond Co., and it is further agreed that the funds so remaining in the business of the company shall not be subject to the payment of any interest.

VII.

The profits and losses of the partnership business shall be borne by the parties in the proportion to the interest designated in Paragraph V. above.

VIII.

Each of the parties shall have an equal voice in the control of the business and operation of the partnership. It shall be the duty of the partnership to keep accurate books of account, which shall be open at all reasonable times to the inspection and examination of each of the partners.

IX.

Upon the dissolution of the partnership at or prior to the death of any of the partners, the said business shall be wound up, debts of the partners to the partnership, if any, paid, and the surplus divided between the partners according to their respective interests as herein set forth.

In Witness Whereof, the parties hereto have caused their signatures to be affixed to these Articles of Partnership on the day and date first above written.

/s/ R. B. HAMMOND,
/s/ W. A. HAMMOND.

State of Oregon,
County of Multnomah—ss.

Be It Remembered that on this 3rd day of February, 1942, before me, the undersigned, a Notary Public in and for said County and State, personally appeared the within named Ross B. Hammond and William A. Hammond who are known to me to be the identical persons described in and who executed the within instrument and acknowledged to me that they executed the same freely and voluntarily.

In Testimony Whereof, I have hereunto set my hand and notarial seal the day and year last above written.

[Seal] /s/ ROSALIE NOVAK,
Notary Public for Oregon.
My Commission Expires: 10/21/42.

PRE-TRIAL EXHIBIT No. 4

AGREEMENT OF EMPLOYMENT

This Agreement, made and entered into on this 3rd day of February, 1942, by and between Ross B. Hammond, sole proprietor, doing business as Ross B. Hammond Co., hereinafter called "First Party," and Henry M. Mason, hereinafter called "Second Party"

Witnesseth:

Whereas the Second Party has been in the employ of the First Party almost continuously for a period of thirteen years, and the First Party recognizing the value of the services, ability, and trustworthiness of the Second Party, and the First Party wishing to permit the Second Party to participate in the profits of the First Party's contracting business; and

Whereas the Second Party has been acting as General Superintendent and General Manager of the construction business of the First Party, with full power of attorney to sign all documents, and subject only to direction of the First Party; and

Whereas the First Party wishing to have the Second Party assume a greater responsibility in connection with the management of the general contracting activities of the First Party;

Now, Therefore, the Parties hereto, agree as follows:

1. Compensation of Second Party and Method of Payment: The First Party hereby agrees that he will pay for the services of the Second Party by permitting him to participate in the net profits

of the operation of the First Party's construction business upon the basis of twenty (20) per cent of the profits earned each calendar year, after all operating, financing, administrative, and other like expenses have been deducted, but before deduction of State and Federal Income Taxes.

It is specifically understood and recognized between the parties that the operations of this business require the use of large sums of money to be available for financing the operation of the construction and contracting business, and, therefore, to insure the continued success of the business and to provide ample working capital, it is hereby agreed that the earnings of the Second Party shall be paid to him on a basis of a drawing account of Five Hundred Dollars (\$500.00) per month, but the Second Party will not be permitted to withdraw in excess of Ten Thousand Dollars (\$10,000.00) per year. Any funds amounting to more than \$10,000.00 per year shall be permitted to remain in the company, to be used for working capital for use in the contracting and constructing business of the First Party. These funds in excess of \$10,000.00 that shall be permitted to remain under the control of the First Party for financing and working capital of the construction business of the First Party shall bear no interest.

2. Cancellation: This agreement may be cancelled by either party giving the other party 90 days' written notice, and/or the same may be changed or modified at any time by mutual consent of the parties hereto. It is further understood

and agreed that said contract will be automatically cancelled if the said Second Party should leave the employ of the First Party of his own accord.

The Second Party further expressly agrees that should he sever his connection with First Party and desire to withdraw the earnings accumulated to his account, he will give one year's written notice thereof to the First Party, and the First Party will not be obligated to pay such funds to the Second Party until one year after receipt of said written notice from the Second Party.

Should Second Party elect to cancel this agreement or voluntarily leave the service of the First Party, then, and in either event, Second Party shall not receive any percentage of any profit earned by the First Party upon any work done or any contracts entered into during such calendar year, and the payment to the said Second Party of an amount equal to \$500.00 per month for the time employed during such current calendar year shall constitute full and complete payment for all services and/or use of the funds of the said Second Party for said current calendar year.

Should the First Party desire to cancel this agreement, he shall notify the Second Party in writing ninety (90) days prior to the date of such cancellation and the compensation due the Second Party shall be upon the basis of twenty (20) per cent of the net profits, as described in paragraph 1 hereof, as shown by the books of the First Party, from January 1st of that year to the date of written notice of cancellation, plus \$1,500.00 to cover

compensation for the 90 days employment service from the date of written notice.

3. Drawing Account: Should the drawing account of \$500.00 per month, or \$6,000.00 per year, as defined in Paragraph 1 above, exceed in any calendar year the percentage of profits to which the Second Party is entitled under this agreement, this difference between the amount of money to which the Second Party is entitled for his services on the basis of this agreement, as outlined in Paragraph 1, shall be charged against any moneys which have accrued to the account of the Second Party, and the amount of money owing the Second Party by the First Party shall be reduced by this amount.

4. Nature of Agreement: It is expressly understood and agreed by and between the parties hereto that this agreement is a contract of employment and that the Second Party does not hereby acquire a proprietary interest in the business of the First Party, but the amounts paid to Second Party shall represent compensation for services rendered.

In Witness Whereof, the parties hereto have affixed their names and seals to the within agreement on the day and date first above given.

ROSS B. HAMMOND CO.,
By /s/ R. B. HAMMOND,
First Party.

/s/ H. M. MASON,
Second Party.

Subscribed and sworn to before me, the undersigned, a Notary Public, on this 3rd day of February, 1942.

[Seal] /s/ ROSALIE NOVAK,
Notary Public for Oregon.
My Commission Expires: 10/21/42.

PRE-TRIAL EXHIBIT No. 5

AGREEMENT OF EMPLOYMENT

This Agreement, made and entered into on this 3rd day of February, 1942, by and between Ross B. Hammond, sole proprietor, doing business as Ross B. Hammond Co., hereinafter called "First Party," and A. V. Petersen, hereinafter called "Second Party"

Witnesseth:

Whereas the First Party recognizing the value of the services, ability, and trustworthiness of the Second Party, and the First Party wishing to permit the Second Party to participate in the profits of the First Party's contracting business; and

Whereas the Second Party has been in the employ of the First Party for more than six years, and in responsible charge of large construction work, and

Whereas the First Party wishing to have the Second Party take more responsibility in connection with all the construction activities of the First Party;

Now, Therefore, the Parties hereto, agree as follows:

1. Compensation of Second Party and Method of Payment: The First Party hereby agrees that he will pay for the services of the Second Party by permitting him to participate in the net profits of the operation of the First Party's construction business upon the basis of fifteen (15) per cent of the profits earned each calendar year, after all operating, financing, administrative, and other like expenses have been deducted, but before deduction of State and Federal Income Taxes.

It is specifically understood and recognized between the parties that the operations of this business require the use of large sums of money to be available for financing the operation of the construction and contracting business, and, therefore, to insure the continued success of the business and to provide ample working capital, it is hereby agreed that the earnings of the Second Party shall be paid to him on a basis of a drawing account of Four Hundred Dollars (\$400.00) per month, but the Second Party will not be permitted to withdraw in excess of Seven Thousand Five Hundred Dollars (\$7,500.00) per year. Any funds amounting to more than \$7,500.00 per year shall be permitted to remain in the company, to be used for working capital for use in the contracting and constructing business of the First Party. These funds in excess of \$7,500.00 that shall be permitted to remain under the control of the First Party

for financing and working capital of the construction business of the First Party shall bear no interest.

2. Cancellation: This agreement may be cancelled by either party giving the other party ninety (90) days' written notice, and/or the same may be changed or modified at any time by mutual consent of the parties hereto. It is further understood and agreed that said contract will be automatically cancelled if the said Second Party should leave the employ of the First Party of his own accord.

The Second Party further expressly agrees that should he sever his connection with First Party and desire to withdraw the earnings accumulated to his account, he will give one year's written notice thereof to the First Party, and the First Party will not be obligated to pay such funds to the Second Party until one year after receipt of said written notice from the Second Party.

Should Second Party elect to cancel this agreement or voluntarily leave the service of the First Party, then, and in either event, Second Party shall not receive any percentage of any profit earned by the First Party upon any work done or any contracts entered into during such calendar year, and the payment to the said Second Party of an amount equal to \$400.00 per month for the time employed during said current calendar year shall constitute full and complete payment for all services and/or the use of the funds of the said Second Party for said current calendar year.

Should the First Party desire to cancel this agreement, he shall notify the Second Party in writing ninety (90) days prior to the date of such cancellation and the compensation due the Second Party shall be upon the basis of fifteen (15) per cent of the net profits, as described in paragraph 1 hereof, as shown by the books of the First Party, from January 1st of that year to the date of written notice of cancellation, plus \$1,200.00 to cover compensation for the 90 days employment service from the date of the written notice.

3. Drawing Account: Should the drawing account of \$400.00 per month, or \$4,800.00 per year, as defined in Paragraph 1 above, exceed in any calendar year the percentage of profits to which the Second Party is entitled under this agreement, this difference between the amount of money to which the Second Party is entitled for his services on the basis of this agreement, as outlined in Paragraph 1, shall be charged against any moneys which have accrued to the account of the Second Party, and the amount of money owing the Second Party by the First Party shall be reduced by this amount.

4. Nature of Agreement: It is expressly understood and agreed by and between the parties hereto that this agreement is a contract of employment and that the Second Party does not hereby acquire a proprietary interest in the business of the First Party, but the amounts paid to Second Party shall represent compensation for services rendered.

In Witness Whereof, the parties hereto have affixed their names and seals to the within agreement on the day and date first above given.

ROSS B. HAMMOND CO.

By /s/ R. B. HAMMOND,

First Party.

/s/ A. V. PETERSEN,

Second Party.

Subscribed and sworn to before me, the undersigned, a Notary Public, on this 3rd day of February, 1942.

[Seal] /s/ ROSALIE NOVAK,

Notary Public for Oregon.

My Commission Expires: 10/21/42.

UNITED STATES
INDIVIDUAL INCOME TAX RETURN

Page 1
1942

OPTIONAL FORM 1040 MAY BE FILED INSTEAD OF THIS FORM IF GROSS INCOME IS REPORTED ON THE CASE BASIS FOR THE CALENDAR YEAR, IS NOT MORE THAN \$200, AND CONSISTS WHOLLY OF SALARY, UNDER OTHER COMPENSATION FOR PERSONAL SERVICES, DIVIDENDS, INTEREST OR ANNUITIES.

FOR CALENDAR YEAR 1942

or fiscal year beginning 1942, and ending 1942

PRINT NAME AND ADDRESS FULLY. (Show Suffixes in Parentheses)

ROSS B. HARRISON

(Street) (Show full names of both husband and wife, if different, in parentheses)

P. O. Box 3901 - 1241 N. Williams Ave.

(Street and number, or rural route)

Portland, Oregon

(Post office)

(County)

(State)

Building Construction

(Occupation)

(Should identify number, if any)

(Name and address of employer)

(If more than one employer, attach statement showing name and address and amount received from each)

(Do not use these spaces)

307
241169

Oregon
RECEIVED
MAY 15 1943
CASH - 42377.5

Items and Instructions No.	INCOME	Amount	Deductible Expenses (Attach itemized statement)	
1. Salaries and other compensation for personal services, \$				
2. Dividends				
3. Interest on bank deposits, notes, etc.				91.64
4. Interest on corporation bonds, etc.				
5. Interest on Government obligations, etc.:				
(a) From line (b), Schedule A				
(b) From line (f), Schedule A				
6. Rents and royalties. (From Schedule B)				(2,688.19)
7. Annuities				20.04
ITEMS 8, 9, AND 10, BELOW (AND PAGES 3 AND 4) NEED NOT BE CONSIDERED UNLESS YOU HAVE INCOME (OR LOSSES) IN ADDITION TO ITEMS ABOVE.				
8. (a) Net gain (or loss) from sale or exchange of capital assets. (From Schedule F)				1,751.09
(b) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule G)				(4,755.42)
9. Net profit (or loss) from business or profession. (From Schedule H)				149,089.15
(State total receipts, from line 1, Schedule H, \$)				
10. Income (or loss) from partnerships; fiduciary income; and other income. (From Schedule I)				
11. Total income in items 1 to 10				\$ 143,508.31
DEDUCTIONS				
12. Contributions paid. (Explain in Schedule C)				\$ 900.50
13. Interest. (Explain in Schedule C)				59.79
14. Taxes. (Explain in Schedule C)				3,881.84
15. Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule C)				
16. Bad debts. (Explain in Schedule C)				
17. Other deductions authorized by law. (Explain in Schedule C)				
18. Total deductions in items 12 to 17				4,842.13
19. Net income (item 11 minus item 18)				\$ 138,666.18
COMPUTATION OF TAX				
20. Net income (item 19 above)	138,666.18	\$ 138,666.18		
21. Less: Personal exemption. (From Schedule D-1)	\$ 1,200.00			
22. Credit for dependents. (From Schedule D-2)	350.00	1,550.00		
23. Balance (surplus net income)	137,116.18	\$ 137,116.18		
24. Less: Item 5 (a) above	\$			
25. Earned income credit. (From Schedule E-1 or E-2)	1,400.00	1,400.00		
26. Balance subject to normal tax	135,716.18	\$ 135,716.18		
27. Normal tax (6% of item 26)				\$ 8,144.30
28. Surtax on item 23. (See Instructions 28)				171.83
29. Total tax (item 27 plus item 28)				8,316.13
30. Total tax (item 29 or line 16, Schedule F)				8,316.13
31. Less: Income tax paid at source				
32. Income tax paid to a foreign country or U.S. possession. (Attach Form 114)				
33. Balance of tax (item 30 minus items 31 and 32)				\$

I declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return made in good faith, for the calendar year or other period for which this Internal Revenue Code and the regulations issued under authority thereof.

Signature of person (other than taxpayer or agent) preparing return (Date) _____

Signature of taxpayer (Date) _____

(If this is a joint return (not made by agent) it must be signed by both husband and wife. A return made by an agent must be accompanied by power of attorney. (See Instructions 33))

Schedule A.—INTEREST ON GOVERNMENT OBLIGATIONS, ETC. (See Instruction 5)

1. Obligations or securities	2. Amount owned at end of year on holding year property interest of such obligations held by estate, trust, partnership, or common trust funds	3. Interest received or accrued during the year	4. Amount of interest received or accrued during the year which is exempt from tax	5. Interest on amount in column 2, net of exemption, and dividends subject to surtax only
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions.	\$	\$	All	
(b) Obligations issued prior to March 1, 1941, under Federal Farm Loan Act, or under such Act as amended.			All	
(c) Obligations of United States issued on or before September 1, 1917.			All	
(d) Treasury Notes issued prior to December 1, 1940, Treasury Bills and Treasury Certificates of Indebtedness issued prior to March 1, 1941.			All	
(e) United States Savings Bonds and Treasury Bonds issued prior to March 1, 1941.			\$5,000	
(f) Obligations of instrumentalities of the United States (other than obligations to be reported in (g) above) issued prior to March 1, 1941.			None	
(g) Dividends on share accounts in Federal savings and loan associations in case of shares issued prior to March 20, 1942.				
(h) Total (enter on item 5 (d), page 1).				\$

1. Treasury Notes issued on or after December 1, 1940, and obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof (enter amount of interest as item 5 (d), page 1).	2. Amount owned at end of year	3. Interest received or accrued during the year (subject to normal tax and surtax)
\$	\$	\$

Schedule B.—INCOME FROM RENTS AND ROYALTIES. (See Instruction 6)

1. Description	2. Amount	3. Depreciation or depletion (attach schedule)	4. Repairs (caption below)	5. Other expenses (caption below)	6. Net profit (column 2 minus sum of columns 3, 4, and 5) (enter as item 6, page 1)
	\$	\$	\$	\$	\$

Explanation of deductions claimed in columns 4 and 5.

Schedule C.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 12, 13, 14, 15, 16, AND 17

1. Item No.	2. Explanation	3. Amount	4. Item No. (Continued)	5. Explanation (Continued)	6. Amount (Continued)
14-Taxes	Real Estate	786.38			
	State Income	3,095.46			
		3,881.84			

Schedule D.—EXPLANATION OF CREDITS CLAIMED IN ITEMS 21 AND 22. (See Instructions 21 and 22)

(1) Personal Exemption			(2) Credit for Dependents		
Status	Number of months during the year in such status	Credit claimed	Name of dependent and relationship	Number of months during the year Under 18 years old 18 years or over	Credit claimed
Single, or married and not living with husband or wife, and not head of family.	12	\$	C. F. Hammond		
Married and living with husband or wife.	12	1,200.00	Father	12	350.00
Head of family (caption below)					

Reason for support if 18 years or over: Father 86 years old. Too age.

Schedule E.—COMPUTATION OF EARNED INCOME CREDIT. (See Instruction 25)

(1) If gross net income is \$3,000 or less, use only this part of schedule	(2) If gross net income is more than \$3,000, use only this part of schedule
Net income (Item 19, page 1)	Earned net income (not more than \$14,000)
\$	\$ 14,000.00
Excess income credit (10% of net income, above)	Net income (Item 19, page 1)
	138,666.18
	Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but do not enter less than \$300)
	1,400.00

QUESTIONS

- Did you file a return for any prior year? Yes If so, what was the latest year? 1941. To which Collector's office was it sent?
- If separate return was made for the current year, state:
 - Name of husband or wife: Katherine S. Hammond
 - Personal exemption, if any, claimed thereon: None
 - Collector's office to which it was sent: Same
- Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
- Was the rate of your salary or wages increased or decreased after October 3, 1942, and before the end of your taxable year? No (Yes or No)
- Did you receive during your taxable year any amount claimed to be non-taxable other than interest reported in Schedule A (see Instruction H)? No If so, attach schedule showing source, nature, and amount of such income.
- Did you at any time during your taxable year own directly or indirectly any stock of a foreign corporation or a personal holding company as defined by section 501 of the Internal Revenue Code? No If so, attach statement required by Instruction K.

DETACH PAGES 3 AND 4 IF NOT USED

Page 2

Schedule F.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS. (See Instruction A)

1. Kind of property (If summary, attach statement of descriptive details not shown below)	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (construct price)	5. Cost or other basis	6. Expenses of sale and cost of improvements subsequent to acquisition or March 1, 1913	7. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (explain in Schedule J)	8. Gain or loss (column 4 plus column 7 minus the sum of columns 5 and 6)	9. Percent gain or loss to the 1913 value or 1913 cost	10. Amount
SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS									
			\$	\$	\$	\$	\$	100	\$
								100	
								100	
								100	

Total net short-term capital gain or loss (enter in line 1, column 3, of summary below)

LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS

Smith Pavar	2/28/39	1942	\$4,000.00	2,232.44	\$1,635.44	3,502.19	50	2,751.09
							50	
							50	
							50	

Total net long-term capital gain or loss (enter in line 2, column 3, of summary below)

SUMMARY OF CAPITAL GAINS AND LOSSES

1. Classification	2. Net short-term capital gain or loss of preceding taxable year (net in excess of net losses for each year), but only to extent of net short-term capital gain of current year	3. Net gain or loss to be taken into account from column 10, above	4. Net gain or loss to be taken into account from partnerships and common trust funds	5. Total net gain or loss taken into account in columns 2, 3, and 4 of this summary
		(a) Gain (b) Loss	(a) Gain (b) Loss	(a) Gain (b) Loss
1. Total net short-term capital gain or loss	\$	\$	\$	\$
2. Total net long-term capital gain or loss	\$	\$	\$	\$
3. Net gain in column 5, lines 1 and 2. (Enter as item 8 (a), page 1)				
4. Net loss in column 5, lines 1 and 2. (The amount to be entered as item 8 (a), page 1, is (1) this item or (2) net income, computed without regard to capital gains or losses, or (3) \$1,000, whichever is smallest)				

COMPUTATION OF ALTERNATIVE TAX

Use only if you had an excess of net long-term capital gain over net short-term capital loss, and item 23, page 1, exceeds \$18,000

1. Net income (item 19, page 1)	\$138,666.28	10. Normal tax (6% of line 9)	\$8,037.91
2. Excess of net long-term capital gain over net short-term capital loss (line 2, column 5 (a), minus line 1, column 5 (b), of summary above)	2,751.09	11. Surtax on line 6. (See Instruction 28)	87,078.62
3. Ordinary net income (line 1 minus line 2)	2,200.00	12. Partial tax (line 10 plus line 11)	95,116.53
4. Credit for dependents. (From Schedule D-2)	350	13. 50% of line 2	875.56
5. Balance (nurtax net income)	1,850.00	14. Alternative tax (line 12 plus line 13)	95,991.87
6. Less: Item 5 (a), page 1	1,400	15. Total normal tax and surtax (item 29, page 1)	90,623.57
7. Earned income credit. (From Schedule E-1 or E-2)	1,400.00	16. Tax liability (line 14 or line 15, whichever is the lesser). (Enter as item 30, page 1)	95,991.87
8. Balance subject to normal tax	133,963.09		

Schedule G.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY OTHER THAN CAPITAL ASSETS (See Instruction 8)

1. Kind of property	2. Date acquired	3. Gross sales price (construct price)	4. Cost or other basis	5. Expenses of sale and cost of improvements subsequent to acquisition or March 1, 1913	6. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (explain in Schedule J)	7. Gain or loss (column 3 plus column 6 minus the sum of columns 4 and 5)
Land 3.839A.	1/1/38	\$900.00	\$2,000.00	\$10.10		(2,110.10)
Land		500.00	4,145.32			(3,645.32)

Total net gain (or loss) (enter as item 8 (d), page 1)

State the family, fiduciary, or business relationship to you, if any, of purchaser of any of the items on this page

If any of such items were acquired by you other than by purchase, explain fully how acquired

RANCH PROFIT & LOSS STATEMENT

Year Ending 12/31/42

	<u>Cattle</u>	<u>Dairy Herd & Heifers</u>	<u>Horses</u>	<u>Grain & Hay</u>	<u>Total</u>
Inventory 12/31/42	18,283.45	4,035.00	640.00	3,415.15	\$ 24,373.60
Sales During Year	13,531.69	563.15	264.00	101.28	14,460.12
	<u>29,815.14</u>	<u>4,598.15</u>	<u>904.00</u>	<u>3,516.43</u>	<u>38,833.72</u>
Inventory 1/1/42	19,065.00	2,990.00	975.00	2,798.22	25,828.22
Purchases During Year	625.08	1,488.06	425.00	3,154.26	5,692.40
	<u>19,690.08</u>	<u>4,478.06</u>	<u>1,400.00</u>	<u>5,952.48</u>	<u>31,520.62</u>

GROSS PROFIT

10,125.06

(496.00)

(2,436.05)

7,313.10

Other Income

Milk and Cream Sales
Misc. Income
TOTAL GROSS INCOME

5,638.29
490.25

6,128.54
\$ 13,441.64

EXPENSES:

Rent
Wages
Repairs
Gas, Oil & Tires
Pasture Beef
General Dairy Exp.
Miscellaneous
Depreciation

2,687.10
5,787.19
1,311.48
807.13
250.00
156.19
494.33
2,242.76

Expenses Forward
Meats, Groc. & Board
Fuel, Light & Power
Phone
Interest
Insurance
Taxes
Total Expense

906.01
649.28
167.72
40.92
407.53
222.19

\$ 16,129.83

NET LOSS YEAR ENDING 12/31/42

\$ (2,688.19)

Plaintiff's Exhibit No. 6—(Continued)

ROSS B. HAMMOND CO.

PROFIT AND LOSS STATEMENT

December 31, 1942

Schedule A

Income:

Gross Profit on Contracts	
(Sch. A-1 attached)	\$195,807.93
Discount Taken	1,515.57
Total Income	\$197,323.50

Expenses:

Automobile Expense	\$ 1,405.54
Advertising Expense	1,227.78
Depreciation Expense	3,336.26
Entertainment	204.90
General Expense	2,954.86
Insurance Expense	1,863.14
Interest Expense	10,839.72
Maintenance and Repair.....	79.57
Office Expense	4,385.15
Office Salaries	11,492.94
Postage Expense	205.00
Professional Expense	5,763.20
Prospective Contract Expense	111.30
Repairs to Completed Contracts.....	521.13
Stationery and Printing	512.34
Taxes	846.49
Travelling Expense	113.63
Job 211 Expense	987.78
Loss account saw	219.00
Bad Debts	486.40
Warehouse Expense	678.22

Total Expense	\$ 48,234.35
---------------------	--------------

Profit from Contracting Business.....	\$149,089.15
---------------------------------------	--------------

and make payment of the installments of tax shown to be due thereon.

In all cases where an extension of time is granted, interest will be collected at the rate of 6% per annum upon each installment, from the due date for filing to the date of payment.

* * * ° This letter or a copy thereof Must accompany the return when it is filed, as authority for the extension of time herein granted. You are requested to comply strictly with this requirement, because of the added work entailed when the extension letter does not accompany the return when filed, placing an added burden on this office in the present war emergency.

Yours very truly,

GUY T. HELVERING,
Commissioner,

By /s/ J. W. MALONEY,
Collector.

1943

10-2

553722

FL

FL

FL

FL

FL

FL

Abstract

Cabana

RECEIVED

MAY 15 1944

DIST - OREGON

PARSONS 22500000

Salary, wages	100.00
---------------	--------

[illegible]

Series: _____

Total _____

Less: Deductible expenses. (An
Compensation after deductible

Dividends _____

Interest on Government obligations, etc.: (a) F

(b) Fr

(c) Not an (or less) than one or more of a

(b) Net gain (or loss) from sale or exchange of property

Rents and royalties. ☒ From Schedule C (1) _____
Net profit (or loss) from other sources _____

(State total receipts, from line 1, Schedule C(2))

Income (or loss) from partnerships; fiduciary income

DEDUCTION

Contributions. (Explain in Schedule D) _____

Taxes. (Explain in Schedule F) (See Instructions D and H for Vi

Losses from fire, storm, shipwreck, or other casualty

Other deductions authorized by law. (Explain in Schedule F)

Total deductions in items 11 to 16_____

Income Tax net income (item 10, col. 1, less item 11, col. 1)

INCOME AND...

Unpaid balance of 1943 Income and Victory Tax.
You may postpone until not later than March 1

of item 19 (c), page 4. Enter the amount paid or received \$20,000, see Schedule L-2

Amount paid with this return (item 20 less item

Refund or If the total of your payments (line 24) enter the difference

Indicate by a check mark (✓) what year

Apply it on my 1944 estimated tax

widened belief is a true, correct, and complete return.

Number of persons (other than taxpayer or his agent) preparing return

6-Name of firm or employer, if any)

11. If this is a joint return (not made by agent), it must be signed by both husband and wife.

Schedule A—INTEREST AND OWNERSHIP OF TAXABLE GOVERNMENT OBLIGATIONS, ETC. (See Instruction 4)

1. Obligation or securities	2. Amount owned at end of year (net value except for United States savings bonds)	3. Interest
Subject to certain only:		
(1) United States savings bonds (cost price) and Treasury bonds issued prior to March 1, 1941.....	\$.....	\$.....
(2) Less: Wholly tax-exempt portion, principal amount not in excess of \$5,000.....
(3) Net taxable interest.....
(4) Obligations of instrumentality of the United States issued prior to March 1, 1941 (other than Federal land bonds, Federal intermediate credit bonds, or joint stock land bonds).....	\$.....	\$.....
(5) Dividends on share accounts in Federal savings and loan associations in case of shares issued prior to March 28, 1942.....
(6) Subtotal for interest (total of lines 3, 4, and 5).....	\$.....
(7) Less: Amortizable bond premium. (See Instruction 14).....
(8) Balance of interest. (Enter as item 4 (a), column 1, page 1).....	\$.....
Subject to normal tax, surtax, and Victory Tax:		
(1) United States savings bonds issued on or after March 1, 1941 (cost price).....	\$.....	\$.....
(2) Other obligations issued on or after March 1, 1941, by the United States or any instrumentality thereof (include also Treasury notes issued on or after December 1, 1940).....
(3) Subtotal for interest (total of lines 1 and 2). (Enter as item 4 (b), column 2, page 1).....	\$.....
(4) Less: Amortizable bond premium. (See Instruction 14).....
(5) Balance of interest. (Enter as item 4 (b), column 1, page 1).....	\$.....

Schedule B—Schedule B (Form 1040) is a separate sheet and should be used in reporting gains and losses from sales or exchanges of capital assets and property other than capital assets, and filed with and as a part of this return.

Schedule C(1)—INCOME FROM RENTS AND ROYALTIES. (See Instruction 7)

1. Kind of property	2. Amount	3. Depreciation or depletion (explain below)	4. Repairs (explain below)	5. Other expenses (explain below)	6. Net profit (columns 2 through 5) (Enter as line 7, page 1)
.....	\$.....	\$.....	\$.....	\$.....	\$.....
.....

Schedule C(2)—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION. (See Instruction 8)

(1) nature of business (2) business name

COST OF GOODS SOLD (Do not include where inventories are an income-deducting factor)		OTHER BUSINESS DEDUCTIONS	
Inventory at beginning of year.....	\$.....	11. Salaries and wages not included as "Labor" (do not deduct compensation for yourself).....	\$.....
Merchandise bought for sale.....	.....	12. Interest on business indebtedness.....	.....
Labor.....	.....	13. Taxes on business and business property.....	.....
Material and supplies.....	.....	14. Losses (explain below).....	.....
Other costs (explain below).....	.....	15. Bad debts arising from sales or services.....	.....
Total of lines 2 to 6.....	\$.....	16. Depreciation, obsolescence, and depletion (explain below).....	.....
Less inventory at end of year.....	.....	17. Rent, repairs, and other expenses (explain below).....	.....
Net cost of goods sold (line 7 less line 8).....	\$.....	18. Amortization of emergency facilities (attach statement).....	.....
Gross profit (line 1 less line 9).....	\$.....	19. Total of lines 11 to 18.....	\$.....
		20. Total of lines 9 and 19.....	\$.....
		21. Net profit (or loss) (line 1 less line 20). (Enter as line 8, page 1).....	\$.....

EXPLANATION OF DEDUCTIONS FOR DEPRECIATION CLAIMED IN COLUMN 3 AND LINE 16, ABOVE

1. Kind of property (building, auto, equipment, etc.)	2. Date acquired	3. Cost or other basis (do not include land or other nondepreciable property)	4. Average life (depreciated by use at end of year)	5. Depreciation claimed (or allowable) in prior years	6. Depreciation cost or other basis to be recovered	7. Estimated life and its commencing date (beginning of depreciation)	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
.....	\$.....	\$.....	\$.....	\$.....
.....

EXPLANATION OF DEDUCTIONS CLAIMED IN COLUMNS 4 AND 5 AND LINES 6, 15, AND 17, ABOVE

1. Explanation	2. Amount	1. Column or line No.	2. Explanation	3. Amount
.....	\$.....	\$.....
.....

Schedule C(3)—INCOME FROM PARTNERSHIPS, FIDUCIARIES, AND OTHER SOURCES. (See Instruction 9)

1. Name and address of partnership, syndicate, etc.	2. Amount
Ross B. Edmund Co.	\$132,135.29
.....
.....
.....

9-2222

COMPUTATION OF INCOME AND VICTORY TAX. (See Tax Computation Instructions)

Form 4

1. Income Tax not included (from 19, page 1)		\$ 125,662.42
2. Less: Personal exemption (from Schedule E)	\$ 1,200.00	
3. Credit for dependents (from Schedule E)	350.00	1,550.00
4. Balance (surplus net income)		\$ 124,462.42
5. Less: Certain interest on Government obligations (from 4, page 1)		
6. Earned income credit (from Schedule E or 1-10)		1,400.00
7. Balance subject to normal tax		\$ 122,712.42
8. Normal tax (6% of line 7)		\$ 7,362.74
9. Surplus on amount in line 4. (See Instructions, page 3 of Instructions)	85,531.54	78,188.80
10. Total Income Tax (line 8 plus line 9)		\$ 85,531.54
11. Less: Income Tax paid to a foreign country or U. S. possession. (Attach Form 1040)		
12. BALANCE OF INCOME TAX	85,531.54	\$ 85,531.54
13. NET VICTORY TAX (line 6 of Victory Tax Schedule, below)	5,773.10	5,773.10
14. Total of lines 12 and 13	91,304.64	\$ 91,304.64
15. Income Tax paid at source on tax-free government bond interest. (See Footnote 1)		
16. Line 14 less line 15	91,304.64	\$ 91,304.64
17. Income Tax for 1942. (See Statement, Form 1123, from Collector) (First, see page 4 of Instructions)		\$ 95,991.87
18. Enter line 16 or 17 whichever is LARGER. (Members of the armed forces see page 4 of Instructions)		\$ 95,991.87
19. FORGIVENESS FEATURE (Don't fill in (a), (b), and (c) below, if either line 16 or 17 is \$50 or less):		
(a) Enter line 16 or 17, whichever is SMALLER	91,304.64	\$ 91,304.64
(b) Enter \$50 or three-fourths of (a), immediately above, whichever is LARGER. This is the FORGIVEN part of the tax		\$ 68,480.36
(c) Enter the UNFORGIVEN part of the tax which is the BALANCE (subtract (b) from (a)). (See Footnote 2)	22,824.28	22,824.28
20. TOTAL INCOME AND VICTORY TAX. (Total of lines 18 and 19 (c))	118,816.15	\$ 118,816.15
21. Less: (a) Income and Victory Tax withheld by employer		
(b) Income Tax paid on 1942 income	17,895.96	
(c) Tax paid on 1943 income on amount of Declaration of Estimated Tax	55,310.76	
(d) Total payments		104,306.70
22. UNPAID BALANCE OF INCOME AND VICTORY TAX. (If line 20 is larger than line 21 (d), enter the difference here and also in Item 28, page 1; if not, see Item 23, page 1)		\$ 14,511.95

FOOTNOTE 1.—If you obtain a refund in line 15, disregard lines 10-14 and (b), complete Schedule L-4 on page 4 of Instructions, and enter result in line 10 (c).

FOOTNOTE 2.—If your entire net income for 1942 or 1943 exceeded \$20,000, regarding you to complete Schedule L-2, enter here the amount shown on line 10 or 27 of such schedule, 2.

Schedule K—VICTORY TAX. (See Tax Computation Instructions)

1. Victory Tax net income (from 19, page 1)		\$ 128,086.05
2. Less: Specific exemption (3624 if return reports income of only one person; otherwise, see Instructions, page 3)		624.00
3. Income subject to Victory Tax (line 1 less line 2)		\$ 127,462.05
4. Victory Tax before credit (5% of line 3)		\$ 6,373.10
5. Victory Tax credit:		
(a) Single person, or married person not living with husband or wife: 25% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent)		\$
(b) Married person living with husband or wife if separate returns are filed: 40% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent)		\$ 600.00
(c) Married person living with husband or wife if only one return or a joint return is filed, or head of a family: 40% (plus 2% for each dependent) of line 4, but not more than \$1,000 (plus \$100 for each dependent). (See Schedule L-2), for exclusion of one dependent by head of a family		\$
6. Net Victory Tax (line 4 less line 5). (Enter in line 13, above)		\$ 5,773.10

Schedule L.—To be used only by individuals whose surplus net income for 1942 or 1943 exceeded \$20,000. Schedule to determine whether Section 6 (c) of the Current Tax Payment Act of 1943 is applicable.

1. Surplus net income for 1942 (from 23, Form 1040 (1942))		\$
2. Surplus net income for 1943 (line 4, above)		\$
3. Surplus net income for base year, \$ plus \$20,000: \$ (Check year used: 1937, 1938, 1939, 1940)		\$

If either line 1 or 2 is greater than line 3, separate Schedule L-2 should be secured from the collector and filed with and as a part of this return.

NOTE.—If a joint return is filed for either 1942 or 1943 and separate returns for the other of such years, enter the aggregate of the separate surplus net incomes for the separate return years. The surplus net income to be entered in line 3 shall be determined in the same manner as the surplus net income entered in line 1 or 2, whichever is the base.

7.4

12/31/43

17,604.35

NET LOSS:

R. B. HAMMOND RANCH

1943 - DEPRECIATION SCHEDULES

Furniture & Household Goods for Help	Date Acquired	Cost	Dep'n Res. 1-1-43	Dep'd Value 1-1-43	Dep'n 1948	Dep'n Res. 12-31-43	Dep'd value 12-31-43
Miscellaneous	1-1-38	500.00	250.00	250.00	50.00	300.00	300.00
Ironer	7-31-38	34.95	15.50	19.45	3.50	19.00	15.95
Second Hand Stove	8-1-38	27.75	13.90	13.85	2.78	16.68	11.07
Washing Machine	8-31-38	30.68	15.35	15.33	3.07	18.42	12.26
2-Chair Seats & Backs	3-31-39	4.00	1.50	2.50	.40	1.90	2.10
Ranch Furniture	9-30-39	40.19	13.06	27.13	4.02	17.08	23.11
Mattress	11-13-39	15.50	4.89	10.61	1.55	6.44	9.06
Ranch Furniture	5-9-40	28.78	15.34	13.44	5.75	21.09	7.69
Total		681.85	329.54	352.31	71.07	400.61	281.24

House	20 Yrs.						
Addition	19 Yrs. - 4 Mo.	5,919.31	1,479.85	4,439.46	295.97	1,775.82	4,143.49
"	19 Yrs. - 2 Mo.	47.29	11.02	36.27	2.55	13.57	33.72
"	18 Yrs. - 11 Mo.	45.08	9.91	35.17	2.38	12.29	32.79
"	18 Yrs. - 7 Mo.	50.79	10.50	40.29	2.68	13.18	37.61
		86.53	16.70	69.83	4.66	21.36	65.17

Total		6,149.00	1,527.98	4,621.02	308.24	1,836.22	4,312.78
Barn	20 Yrs.	2,630.00	990.50	1,639.50	141.50	1,132.00	1,698.00

Shops-Sheds & Farm Bldgs.	12-1-38	967.04	201.51	765.53	49.35	250.66	716.18
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Diary Equipment	7-1-39	360.86	315.77	45.09	45.09	360.86	
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Power Line	7-1-39	73.28	64.12	9.16	9.16	73.28	
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R. S. HALLORD - RANCH

1943 - DEPRECIATION SCHEDULE

Machinery & Equipment

Cream Separator
 Wagon In. Wheels and Plow
 Generator - 32 Volt
 Oliver Superior - Grain Drill
 P-20 Tractor and Appliances
 M. C. Daring Soil Pulveriser
 2- Stock Saddles
 1- Used Stock Saddle
 Line Drill
 Whis - Electric Tools
 Hay Fork, Truck & Carriage
 2- Rubber Tired Hay Wagons
 Drag Harrow
 Feed Hog
 Sawyerman #12 Land Leveller
 Manure Spreader
 Ditcher
 Used Gasoline Pump
 J. D. Staeker
 2- J. D. Sweep Rakes
 1940 Dodge Truck
 1939 Plymouth Station Wagon
 1941 - 2 Ton Dodge Truck
 Case Hay Chopper
 Power Mower

Date Acquired	Cost	Dep'n Res. 1-1-43	Dep'd Value 1-1-43	Dep'n 1943	Dep'n Res. 12-31-43	Dep'd Value 12-31-43
1938	68.44	68.44	---	---	68.44	---
3-135	55.00	55.00	---	---	55.00	---
8-135	89.75	89.75	---	---	89.75	---
4-3-36	146.00	146.00	---	---	146.00	---
10-28-37	2,069.90	2,069.90	---	---	2,069.90	---
4-30-38	130.05	121.38	8.67	8.67	130.05	---
8-31-38	121.50	105.30	16.20	16.20	121.50	---
10-3-38	25.00	25.00	---	---	25.00	---
1-20-39	92.50	74.00	18.50	18.50	92.50	---
11-1-38	6.95	7.46	1.49	1.49	8.95	---
7-134	14.70	8.82	5.88	1.47	10.29	4.41
1-20-39	75.00	58.70	16.30	15.00	73.70	1.30
1-20-39	17.00	13.35	3.65	3.40	16.75	.25
1-20-39	51.00	40.10	10.90	10.20	50.30	.70
3-15-39	237.00	179.60	57.40	47.40	227.00	10.00
3-15-39	204.00	154.70	49.30	40.80	195.50	8.50
6-1-41	113.50	35.95	77.55	22.70	58.65	54.85
11-15-39	22.00	13.76	8.24	4.40	18.16	3.84
6-1-41	184.00	58.27	125.73	36.80	95.07	88.93
6-1-41	188.00	59.53	128.47	37.60	97.13	90.87
4-30-40	894.00	596.00	298.00	223.50	819.50	74.50
10-11-40	700.00	393.75	306.25	175.00	568.75	131.25
10-26-40	1,706.00	924.08	781.92	426.50	1,350.58	355.42
1-1-42	480.00	96.00	384.00	96.00	192.00	288.00
9-21-43	266.00	---	260.00	15.50	15.50	244.50

Total

7,953.29 5,394.84

1,201.13 6,595.97 1,357.32

Schedule B (Form 1040)

UNITED STATES

DEPARTMENT OF THE TREASURY
BUREAU OF INTERNAL REVENUE

SCHEDULE OF GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS AND PROPERTY OTHER THAN CAPITAL ASSETS

(TO BE FILED WITH THE COLLECTOR OF INTERNAL REVENUE WITH FORM 1040)

For Calendar Year 1943

Or fiscal year beginning, 1943, and ending, 1944
(See instructions on other side)

Name of taxpayer R. B. HAZMOND
Address P. O. Box 3901, Portland 8, Oregon

CAPITAL ASSETS

1. Kind of property (If necessary, attach statement of description (don't set down below))	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (contract price)	5. Cost or other basis	6. Expense of sale and cost of improvements subsequent to acquisition or March 1, 1913	7. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (attach Schedule)	8. Gain or loss (column 6 plus column 7 less the sum of columns 3 and 4)	9. Gain or loss to be taken into account
SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS								
			\$	\$	\$	\$	\$	100
								100
								100
								100
Total net short-term capital gain or loss (enter in line 1, column 2, of summary below)								\$

LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS								
Property -			\$	\$	\$	\$	\$	50
Ten. 13 R10-12								50
Jefferson City	9/18/42	9/3/43	4,300.00	4,200.00			100.00	50
								50
Total net long-term capital gain or loss (enter in line 2, column 2, of summary below)								\$ 50.00

SUMMARY OF CAPITAL GAINS AND LOSSES

1. Classification	2. Net gain or loss to be taken into account from column 10, above		3. Net gain or loss to be taken into account from partnerships and common trust funds		4. Total net gain or loss taken into account on columns 2 and 3 of this summary	
	(a) Gain	(b) Loss	(a) Gain	(b) Loss	(a) Gain	(b) Loss
1. Total net short-term capital gain or loss	\$	\$	\$	\$	\$	\$
2. Total net long-term capital gain or loss	\$ 50.00	\$	\$	\$	\$ 50.00	\$
3. Capital loss carry-over (attach statement)						
4. Net gain in column 4, lines 1, 2, and 3. (Enter as item 6 (a), page 1, Form 1040)					\$ 50.00	
5. Net loss in column 4, lines 1, 2, and 3. (The amount to be entered as item 6 (a), page 1, Form 1040, is (1) this item or (2) net income, computed without regard to capital gains or losses, or (3) \$1,000, whichever is smallest)						

COMPUTATION OF ALTERNATIVE TAX

Use only if you had an excess of net long-term capital gain over net short-term capital loss, and line 4, page 4, Form 1040, exceeds \$18,000

1. Net income (item 18, page 1, Form 1040)	\$125,662.40	10. Normal tax (6% of line 9)	\$ 7,359.74
2. Excess of net long-term capital gain over net short-term capital loss (line 2, column 4 (a), less the sum of line 1, column 4 (b), and line 3 of summary above)	50.00	11. Surtax on line 6. (See Surtax Table in Form 1040 Instructions)	78,149.30
3. Ordinary net income (line 1 less line 2)	\$125,612.40	12. Partial tax (line 10 plus line 11)	\$ 85,509.04
4. Less: Personal exemption. (From Schedule 1-(1), Form 1040)	\$ 1,200.00	13. 50% of line 2	25.00
5. Credit for dependents. (From Schedule 1-(2), Form 1040)	350.00	14. Alternative tax (line 12 plus line 13)	\$ 85,534.04
6. Balance (surtax net income)	\$124,062.40	15. Total normal tax and surtax (line 8 plus line 9, page 4 of Form 1040)	\$ 85,551.54
7. Less: Item 4 (a), page 1, Form 1040	\$	16. Tax liability (line 14 or line 15, whichever is the lesser). (Enter as line 10, page 4, Form 1040)	\$ 85,534.04
8. Earned income credit. (From Schedule J-(1) or J-(2), Form 1040)	1,400.00		
9. Balance subject to normal tax	\$122,662.40		

PROPERTY OTHER THAN CAPITAL ASSETS

1. Kind of property	2. Date acquired	3. Gross sales price (contract price)	4. Cost or other basis	5. Expense of sale and cost of improvements subsequent to acquisition or March 1, 1913	6. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (attach Schedule)	7. Gain or loss (column 3 plus column 4 less the sum of columns 5 and 6)
		\$	\$	\$	\$	\$
Total net gain (or loss) (enter as item 6 (b), page 1)						

State the family, fiduciary, or business relationship to you, if any, of purchaser of any of the items on this page

If any of such items were acquired by you other than by purchase, explain fully how acquired

Plaintiff's Exhibit No. 6—(Continued)
Treasury Department
Internal Revenue Service
Portland, Oregon

[Stamp]: Received May 15, 1944.

IT:RPK:E

March 8, 1944

Mr. R. B. Hammond
c/o P. O. Box 3901
Portland 8, Oregon

Dear Sir:

Receipt is acknowledged of your application of recent date, requesting for the reasons therein stated, an extension of time within which to file your return of income for the year 1943.

An extension of time to May 15, 1944 is hereby granted, within which to file the return in question and make payment of the amount due March 15, 1944, as shown by the return.

In all cases where an extension of time is granted, interest will be collected at the rate of 6% per annum, on the amount due as of March 15, 1944, to date of payment.

This letter or a copy thereof Must accompany the return when it is filed, as evidence of the extension of time herein granted, in order that the return may not be listed as delinquent.

Yours very truly,

JOSEPH D. NUNAN, JR.,
Commissioner,

By /s/ J. W. MALONEY,
Collector.

Plaintiff's Exhibit No. 6—(Continued)

Statement of Tax Liability and Payments on
Account of Individual Income Tax
Return for 1942

To Federal Income Taxpayer named below: For the purpose of assisting you in the preparation of your 1943 income tax return, there is shown hereon certain information taken from the records of this office pertaining to your Federal income tax account for the taxable year 1942. This information must be entered on your 1943 return, and this Statement should be attached to the return in support of the entries. *Do not make any changes in this Statement.* If the figures do not agree with your records, return the Statement *at once* with a letter of explanation

Collector of Internal Revenue,
Portland, Oregon

241169

Ross B. Hammond
PO Box 3901
1241 N. Williams Ave.
Portland, Oregon

Total tax shown on your 1942 income tax return: \$95,991.87. Paid at time of filing and as result of bills subsequently issued: \$47,995.94.

This statement should be attached to your 1943 income tax return when filed with Collector of Internal Revenue.

PLAINTIFF'S EXHIBIT No. 12

[Red Pencil]: 1938
Treasury Department
Internal Revenue Service

Seattle, Washington, February 3, 1940

Seattle Division

[Stamp]: Received, Ross B. Hammond Co., Feb.
5, 1940.

[Stamp]: Paid Tax, \$291.56; Int., \$16.08; To-
tal, \$307.64. 2/22/40. No. 4891.

No. 15059-O

Ross B. Hammond,
1214 Spalding Bldg., Portland, Oregon.

In re: Income tax

Date of Report: January 24, 1940

Year(s) Examined: 1938

Sir:

There is enclosed for your information and files a copy of a report covering the examination of your income tax return(s) for the year(s) indicated, recently made by a representative of this office. You have indicated your agreement to the adjustment of tax liability shown in the report.

The item checked below explains briefly how settlement of the agreed tax liability will be accomplished through the office of the Collector of Internal Revenue for your district.

Respectfully,

/s/ GEO. C. EARLEY,

Internal Revenue Agent in Charge.

Enclosure.

Plaintiff's Exhibit No. 12—(Continued)

Deficiency: The Collector will present to you at an early date a bill for payment of the tax, together with interest, at which time remittance should be made to that official, provided you have not already paid the full amount due.

* * *

January 24, 1940.

Name of taxpayer, Ross B. Hammond.

Statement of Total Tax Liability

Income Tax, Year, 1938; Tax Previously Assessed, \$1,209.15; Adjustments Proposed in This Report, Deficiency: \$291.56; Correct Tax Liability: \$1,500.71.

* * *

Note.—The amount shown in the first column of the above statement is the amount assessed on the original return, except as indicated in the following summary of adjustments previously made.

* * *

Preliminary Statement

Additional tax was principally caused by taxpayer understating farm inventory and error in accrual of interest.

Findings were explained to the taxpayer who has agreed thereto.

Taxpayer was a married man living with his wife during the entire year. Wife had no separate income and did not file a return. Taxpayer was

Plaintiff's Exhibit No. 12—(Continued)

sole support during the year of his aged father, as a dependent. See affidavit attached to the return in this connection.

Schedule No. 1

Block Adjustments—1938

	Return	Additions	Deductions	Amended
3. Interest	1,594.36		(a) 1,431.70	162.66
5. Interest	387.50			387.50
6. Loss on ranch	(4,792.24)	1,699.00	160.00	(3,253.24)
8. Discounts	3,512.03		(a) 3,512.03	
		608.51		
9. Business	19,854.71	3,085.10	(a)	23,548.32
10a. Short term gain	1,743.75			1,743.75
11. Other	15.00		(a) 15.00	
12. Total	22,315.11			22,588.99
13. Contributions	275.00			
14. Interest	2,688.70	1,301.54		275.00
15. Taxes	1,831.90	572.09	(a)	1,387.16
			(a)	1,259.81
19. Total deductions	4,795.60			2,921.97
20. Net income	17,519.51	7,266.24	5,118.73	19,667.02

Schedule 1-A

Explanation of Items

(a) Items designated (a) in Schedule 1 relate to the taxpayer's contracting business and have been transferred to line 9 of Schedule 1 accordingly, viz:

Plaintiff's Exhibit No. 12—(Continued)

Interest	\$1,431.70	
Discount taken	3,512.03	
Rent equipment		15.00
Interest expense	\$1,301.54	
Taxes	572.09	
Net adjustment, line 9.....	(3,085.10)	
	<hr/>	<hr/>
	\$4,958.73	\$4,958.73

These transfers do not affect net income on line 20, Schedule 1, as the above computation shows.

Line 6, Schedule No. 1

\$1,699.00	Adjustment to increase farm inventory as at December 31, 1938. See further explanation in Exhibit C.	
160.00	Adjustment to increase purchases, viz:	
	Purchases per line 5, page 2, Form 1040F.....	\$107.95
	As corrected	267.95
		<hr/>
	Difference	\$160.00

Difference represents the cost of a team of work horses purchased in 1938 and included in the closing inventory, as amended.

Line 9, Schedule No. 1

\$608.51	—Accrued interest on Federal Income Tax deficiencies for years 1934, 1936 and 1937.	
	Per books (interest accrued for 1938 only).....	\$1,237.83
	Corrected	629.32
		<hr/>
	Difference	\$ 608.51

Plaintiff's Exhibit No. 12—(Continued)

Schedule No. 2

Computation of Tax

1. Net income (from Schedule 1).....	\$19,667.02
2. Less: Personal exemption	\$2,500.00
3. Credit for dependents.....	400.00 2,900.00
4. Balance (surtax net income).....	16,767.02
5. Less: Interest on U. S. Treasury Bonds..\$	387.50
6. Earned income credit (see below).....	470.97 858.47
7. Balance subject to normal tax.....	15,908.55
8. Normal tax at 4%	\$ 636.34
9. Surtax on item 4.....	864.37
10. Total tax	1,500.71
13. Total tax assessable	1,500.71
14. Tax previously assessed	1,209.15
15. Additional tax to be assessed.....	291.56

Computation of Earned Income Credit

Schedule 1, Line 9—Profit \$23,548.32

\$23,548.32 at 20% equals earned income or.....	\$4,709.66
10% of \$4,076.34 equals.....	470.97

Plaintiff's Exhibit No. 12—(Continued)

EXHIBIT A

Balance Sheet Contracting Business as at 12-31-38

Assets:	Books	Dr.	Cr.	Amended
Cash.....	4,082.45	No Change		
Accts. Rec.....	22,816.44	"		
State capital.....	836.25	"		
U. of Ore. Med. School				
Library.....	1,054.74	"		
Deposits.....	175.00	"		
Accts. Rec. M.				
Knudsen Co.....	1,227.48	"		
Prepaid Expense.....	622.70	"		
Material & Supplies.....	1,427.23	"		
Fixed Assets:				
Autos.....	2,938.00	"		
Furniture & Fixtures.....	4,100.74	"		
Machinery & Equipment...	50,100.28	"		
Totals.....	89,381.31			89,381.31
Liabilities:				
Accounts Payable.....	8,453.55	"		8,453.55
Accrued Payroll.....	213.84	"		213.84
Accrued taxes.....	187.41	"		187.41
Bonus Payable (1936).....	18,000.00	"		18,000.00
Reserve for add'l. Inc.				
tax assessment.....	21,009.55	10,520.83 (a)		10,488.72
Accrued Int. on def.....	2,598.84	1,136.61 (a)		1,462.23
Reserve for Deprn.				
Autos.....	1,008.35			1,008.35
Furn. & Fixt.....	3,178.05			3,178.05
Mach. & Equip.....	47,641.36			47,641.36
Net Worth				
R. B. Hammond.....	(12,909.64)	(b) 11,657.44		(1,252.20)
Totals.....	89,381.31	11,657.44	11,657.44	89,381.31

Plaintiff's Exhibit No. 12—(Continued)

Federal income tax deficiencies of predecessor R. B. Hammond, Inc., as finally determined. See Conference Revision Report on taxpayer for 1937, dated September 1, 1939. Adjustment to bring into agreement therewith.

Year 1934	\$3,745.54		
1936	4,327.05	Accrued Int.	Accrued Int.
1937	2,416.13	1938	12/31/38
	<hr/>		
	10,488.72		
Accrued Interest thereon			
to 12-31-37	\$ 832.91	629.32	1,462.23
	<hr/>		
Total per Conf. Rpt.....	\$11,321.63		
(b) Net adjustment to surplus.			

EXHIBIT B

Net Worth—Contracting Business

As per Books:	Dr.	Cr.	Balance
12-31-37 balance (Corp. capital & surplus trans.).....		43,114.51	43,114.51
1938			
R. B. Hammond Acct. transf.....	8,101.40		
Notes Rec. Transferred.....	1.00		
Stock & Bonds Transferred.....	13,940.70		
Adj. Morrison Knudsen Co. Acct.....	411.35		20,660.06
Net profit—Sch. D of return.....		19,854.71	
a) Items income & deduction reported elsewhere on return 1938:			
Discount taken		3,512.03(a)	
Interest		1,431.70(a)	

Plaintiff's Exhibit No. 12—(Continued)

Exhibit B—(Continued):

As per Books:	Dr.	Cr.	Balance
Profit on sale U. S. Treas. Bonds			
line 10(a)		1,743.75(a)	
Rent of equipment Line 11.....		15.00(a)	
Contributions Line 13.....	235.00(a)		
Interest—Line 14	1,301.54(a)		
Taxes—Line 15	572.09(a)		
Part of 1937 Fed. I. T. on Corp. Accr.....	1,819.21		
Withdrawals R. B. Hammond.....	56,199.05		
12-31-38 Balance		(12,909.64)	(12,909.64)
	<hr/>	<hr/>	
Totals.....	82,581.34	82,581.34	
	<hr/>	<hr/>	
Amended:			
12-31-37 Bal. (See Conf. Rev. Rpt.			
dated 9-1-39)		44,251.14	44,251.14
1938			
R. B. Hammond Acct. Rec. Transferred	8,101.40		
Notes Receivable Transferred	1.00		
Stocks & Bonds Trans.....	4,663.00		
Books \$13,940.70			
Adj. 9,277.70(a)			
	<hr/>		
Net Profit, Sch. No. 1.....		23,548.32	
Gain on sale Treas. Bds. Line (10a)			
Sch. 1		1,743.75	
Contributions incl. line 13 Sch. 1.....	235.00		
Withdrawals	56,199.05		
R. B. Hammond, Inc. Fed. IT 1933			
deficiency	1,300.17		
Interest on deficiency to 12-31-37.....	295.79		
12-31-38 balance		(1,252.20)	(1,252.20)
	<hr/>	<hr/>	
Totals.....	70,795.41	70,795.41	

(a) See 1937 R.A.R. and Conference revision report dated 9-1-39 showing adjustment of values upon liquidation of the corporation. Taxpayer, as sole stockholder, liquidated the corporation of Ross B. Hammond, Inc., as at 12-31-37.

Plaintiff's Exhibit No. 12—(Continued)

EXHIBIT C

Farm Inventory as of 12-31-38

6200 lbs. Clover seed at 10c.....	\$ 620.00
14 pigs at \$6.00	84.00
Dairy Cows:	
Z 536792 Bonny, 5 years	80.00
536795 Cherry, 5 years	35.00
536788 Shorty, 12 years	35.00
536794 Opal, 5 years	35.00
536789 June, 4 years	50.00
536797 Peggy, 5 years	35.00
536793 July, 4 years	35.00
536798 Pearl, 3 years	70.00
Mary, 3 years	35.00
591557 ———, 2 years	30.00
527125 ———, 2 years	30.00
52726 ———, 2 years	30.00
591558 ———, 2 years	30.00
591556 ———, 2 years	30.00
One calf, 6 months	25.00
X 405447 ———, 3 years	50.00
One steer, 1 year	40.00
Work Horses:	
Buck, 12 years	25.00
Tony, 6 years	60.00
Chief, 6 years	60.00
Junior, 7 years	50.00
Pard, 7 years	30.00
Lady, 3 years	30.00
Strawberry, 5 years	30.00
Star, 2½ years	50.00
Jack, 2½ years	30.00
Barley—4 tons at \$25.00	100.00
Oats—1 ton at \$25.00	25.00
Hay—45 tons at \$12.00	540.00
<hr/>	
Total Inventory 12-31-38	\$2,409.00
Per Form 1040 F	710.00
<hr/>	
Difference—income increased	\$1,699.00

PLAINTIFF'S EXHIBIT No. 13

1938

Treasury Department
Internal Revenue Service

Seattle, Washington,
March 19, 1941.

Seattle Division

Mr. Ross B. Hammond
1214 Spalding Building
Portland, Oregon

In re: Income tax

Date of Report: Jan. 27, 1941

Year Examined: 1938

There is enclosed for your information and files a copy of a report covering the examination of your income tax return(s) for the year(s) indicated, recently made by a representative of this office. You have indicated your agreement to the adjustment of tax liability shown in the report.

The item checked below explains briefly how settlement of the agreed tax liability will be accomplished through the office of the Collector of Internal Revenue for your district.

Respectfully,

/s/ GEO. C. EARLEY,

Internal Revenue Agent in
Charge.

DLA/ac

Enclosure.

Plaintiff's Exhibit No. 13—(Continued)

Deficiency: The Collector will present to you at an early date a bill for payment of the tax, together with interest, at which time remittance should be made to that official, provided you have not already paid the full amount due.

* * *

SUPPLEMENTAL REPORT

Name of taxpayer, Ross B. Hammond.

Date of Report: Jan. 27, 1941.

Statement of Total Tax Liability

Income Tax, Year: 1938; Tax Previously Assessed, \$1,500.71; Adjustments Proposed in This Report, Deficiency: \$157.78; Correct Tax Liability: \$1,658.49.

* * *

Note.—The amount shown in the first column of the above statement is the amount assessed on the original return, except as indicated in the following summary of adjustments previously made.

Year 1938—Income Tax

Original tax.....	\$1,209.15
Deficiency assessed, 1940.....	291.56

Net Tax Previously Assessed..\$1,500.71

Preliminary Statement

The causes of the additional tax were taxpayer's erroneous deductions for interest and club dues.

Changes were discussed with Mr. Hammond, who has executed Form No. 870 agreeing to the additional tax as shown by this report.

Plaintiff's Exhibit No. 13—(Continued)

Schedule 1

Year Ended: 12/31/38

Adjustments to Net Income

Net income as disclosed by Revenue Agent's Report	
1/24/40	\$19,667.02
As corrected	20,617.14
Net adjustment as computed below.....	950.12
Unallowable deductions and additional income:	
(a) Accrued interests	\$629.32
(b) Club dues not allowable.....	320.80
Total	\$ 950.12
Net adjustment	\$ 950.12

Schedule 1-A

Explanation of Items

- (a) Accrued interest unallowable, \$629.32. When Ross B. Hammond Company, a corporation, was dissolved in 1937, there were outstanding against it Federal income tax assessments for several years. These assessments were in dispute and final settlement was made in 1939 at which time this taxpayer, as transferee, paid the additional tax and interest. In a previous report there was allowed as a deduction \$629.32 as interest which accrued on these taxes for the year 1938. It is now held that interest paid by a transferee on deficiency of a dissolved corporation is not an allowable deduction. See I.T. 3156 C.B. 1938-1 Page 213: Also, Appeal of Ben P. O'Niel 18 B.S.A. 1036.

Plaintiff's Exhibit No. 13—(Continued)

- (b) Club dues not allowable, \$320.80. Taxpayer is a member of a local club known as the Arlington Club. At various times he has used this club for the purpose of entertaining prospective customers. This club is primarily a social club and the greater portion of the expense connected therewith is of a personal nature. However, a portion of the expense is applicable to business and it has been estimated that an allocation of $\frac{1}{3}$ is a fair allowance for business. Adjustment has been made as follows:

Total dues and expenses	\$494.40
Less: Taxes on dues allowable in full.....	13.20
<hr/>	
Balance	\$481.20
Allocated to business $\frac{1}{3}$	160.40
Allocated to personal $\frac{2}{3}$	320.80

Schedule 2—Year ended Dec. 31, 1938

Computation of Tax

1. Net in come from Schedule 1.....	\$20,617.14
2. Less: Personal exemption	\$2,500.00
3. Credit for dependents	400.00 2,900.00
<hr/>	
4. Balance	\$17,717.14
6. Less: Earned income credit	477.38
<hr/>	
7. Balance subject to normal tax.....	\$17,239.76
8. Normal tax at 4%	\$ 689.60
9. Surtax on item at 4%.....	968.89
13. Total tax assessable	\$ 1,658.49
14. Tax previously assessed	1,500.71
15. Additional tax to be assessed	157.78

Plaintiff's Exhibit No. 13—(Continued)

Computation of Earned Income Credit:

Business income per Revenue Agent's report 1/24/40.....	\$23,548.32
Add: Club dues not allowable	320.80
Business income amended	23,869.12
<hr/>	
Earned income 20% x 23869.12	\$ 4,773.82
Earned income credit 10% x 4771.82.....	477.38

PLAINTIFF'S EXHIBIT No. 14

Treasury Department
Internal Revenue Service

Seattle, Washington,
March 19, 1941.

Seattle Division

[Penciled]: Overassessment, 3/9/43, \$132.59.

Mr. Ross B. Hammond
1214 Spalding Building
Portland, Oregon

In re: Income Tax

Date of Report: Jan. 27, 1941

Year Examined: 1939

Sir:

There is enclosed for your information and files a copy of a report covering the examination of your income tax return(s) for the year(s) indicated, recently made by a representative of this office. You have indicated your agreement to the adjustment of tax liability shown in the report.

The item checked below explains briefly how settlement of the agreed tax liability will be accom-

Plaintiff's Exhibit No. 14—(Continued)

plished through the office of the Collector of Internal Revenue for your district.

Respectfully,

/s/ GEO. C. EARLEY,

Internal Revenue Agent in Charge.

DLA/ac. Enclosure.

Deficiency: The Collector will present to you at an early date a bill for payment of the tax, together with interest, at which time remittance should be made to that official, provided you have not already paid the full amount due.

* * *

Name of taxpayer, Ross B. Hammond.

Dated of Report: Jan. 27, 1941.

Statement of Total Tax Liability

Income Tax, Year: 1939; Tax Previously Assessed: \$3,080.51; Adjustments Proposed in This Report, Deficiency: \$1,497.61; Correct Tax Liability: \$4,578.12.

* * *

Note.—The amount shown in the first column of the above statement is the amount assessed on the original return, except as indicated in the following summary of adjustments previously made.

Preliminary Statement

The principal cause of the additional tax was overstatement of cost of one contract.

Plaintiff's Exhibit No. 14—(Continued)

Changes were discussed with Mr. Hammond, who has executed Form No. 870 agreeing to the immediate assessment of the deficiency as shown.

Taxpayer was a married man living with his wife all during the year 1939. He is the sole support of his father who is past 83 years of age. This dependent makes his home with the taxpayer.

Schedule 1—Year: 1939

Block Adjustments

	Return	Add. to Income	Corrected
2. Dividends	\$ 206.00		\$ 206.00
3. Interest	262.09	(b) \$ 60.00	322.09
6. Farm Loss	(9,521.95)		(9,521.95)
9. Business	38,542.88	(a) 6,543.97	45,086.85
11. Other income	63.82		63.82
12. Total Income	29,552.84		36,156.81
13. Contributions	294.00		294.00
14. Interest	663.87		663.87
15. Taxes	498.08		498.08
19. Total deductions	1,455.95		1,455.95
22. Net Income	28,096.89	6,603.97	34,700.86

Schedule 1-A

Explanation of Items

(a) Line No. 9, Business Income increased as follows:

- (1) Cost of Job No. 196 overstated..\$5,000.00
- (2) Interest deduction not allowable.. 1,227.07
- (3) Club dues not allowable..... 316.90

Total increase\$6,543.97

(1) Cost of Job No. 196 overstated, \$5,000.00.
Amount accrued on books as a contingent lia-

Plaintiff's Exhibit No. 14—(Continued)

bility and charged to cost of Job No. 196. This accrued was made to cover estimated cost of bricks which were placed in 1939 but which were bleeding badly. It appeared as though these bricks would have to be replaced, but subsequent events proved that several washings were sufficient. Cost of washings were paid by brick manufacturer. Taxpayer has reported the gain on this contract on the percentage of completion basis and the deductions are limited to amounts actually expended on the job. See Section 19.42-4 of Internal Revenue Code.

- (2) Interest deduction not allowable, \$1,227.07. When the Ross B. Hammond Company, a corporation, was dissolved in 1937, there were outstanding against it Federal income tax assessments for several years. These assessments were in dispute but were finally settled in the year 1939. This taxpayer, as transferee of the assets of the corporation, paid the additional tax including interest in the amount of \$1,856.39. Deduction was claimed for \$1,227.07 of this amount computed as follows:

Interest paid	\$1,856.39
Accrued in 1938.....	629.32
Balance	\$1,227.07

It has been held that interest paid by a transferee on deficiency of a dissolved corporation is not an allowable deduction to the individual.

Plaintiff's Exhibit No. 14—(Continued)

See L.T. 3156 C.B. 1938-8 page 213. Also the appeal of Ben P. O'Niel 18 B.S.A. 1036.

- (3) Club dues not allowable, \$316.90. Taxpayer is a member of a local club known as the Arlington Club. At various times he has used this club for the purpose of entertaining prospective customers. This club is primarily a social club and the greater portion of the expense connected therewith is of a personal nature. No segregation was made by the taxpayer between the portion allowable for business purposes and the portion attributable to his personal expense. It has been estimated that $\frac{1}{3}$ is a fair allocation of the portion allowable for business and adjustment has been made as follows:

Total Arlington Club expense including dues.....	\$488.55
Deduct taxes on dues allowable in full	13.20
Balance	<u>\$475.35</u>
Portion allocated to business $\frac{1}{3}$	158.45
Portion allocated in personal $\frac{2}{3}$	316.90
(b) Interest income increased	\$ 60.00
Interest on Oregon Pulp & Paper Company bonds received by Mr. Hammond and not included in interest shown on return.	

Schedule 2—Year: 1939

Computation of Tax

1. Net income from Schedule 1.....	\$34,700.86
2. Less: Personal exemption	\$2,500.00
3. Credit for dependents	400.00 2,900.00

Plaintiff's Exhibit No. 14—(Continued)

4. Balance	\$31,800.86
6. Less: Earned income credit	901.74
<hr/>	
7. Balance subject to normal tax.....	\$30,899.12
8. Normal tax at 4%.....	\$1,235.96
9. Surtax on Item 4.....	3,342.16
13. Total tax assessable	4,578.12
14. Tax previously assessed	3,080.51
15. Additional tax to be assessed.....	1,497.61
<hr/>	
Computation of Earned Income Credit:	
Business income	\$45,086.85
Earned income 20%	9,017.37
Earned income credit 10%	901.74

PLAINTIFF'S EXHIBIT No. 15

Treasury Department
Internal Revenue Service

Seattle, Washington, March 23, 1943

Seattle Division

[Stamp]: Ross B. Hammond Co., Received Mar.
25, 1943.

Mr. Ross B. Hammond
1214 Spalding Building
Portland, Oregon

In re: Income Tax
Date of Report: March 1, 1943
Year(s) Examined: 1939

Sir:

There is enclosed for your information and files a copy of a report covering the examination of your income tax return(s) for the year(s) indicated, recently made by a representative of this office. You have indicated your agreement to the adjustment of tax liability shown in the report.

Plaintiff's Exhibit No. 15—(Continued)

The item checked below explains briefly how settlement of the agreed tax liability will be accomplished through the office of the Collector of Internal Revenue for your district.

Respectfully,

/s/ A. R. STOCKTON,

Internal Revenue Agent in Charge.

Enclosure.

* * *

Overassessment: After the overassessment(s) have been certified to the Collector by the Commissioner of Internal Revenue, you will receive a check in payment of the overassessment and interest, provided there are no outstanding taxes against which the amount should be credited.

Name of Taxpayer, Ross B. Hammond.

Date of Report, 3/1, 1943.

Examining Officer, Keith L. Leslie.

Index:

Statement of Total Tax Liability

Year: 1939; Liability, Tax: \$4,445.53; Previously Assessed*, Tax: \$4,578.12; Adjustments Proposed in This Report, Tax, Overassessment: \$132.59.

*Summary of Adjustments of Assessments

Year 1939—Income Tax

Originally assessed\$3,080.51

Deficiency assessed March, 1941.. 1,497.61

Net previous assessments....\$4,578.12

* * *

Plaintiff's Exhibit No. 15—(Continued)

Preliminary Statement

The cause of overassessment for the year 1939 was the assessment by the State of Oregon of additional state taxes for that period, payment of which was made in 1941.

Through the taxpayer's bookkeeper, R. Novak, he was advised to protect his interests by filing a claim for refund prior to the expiration of the statute of limitations on March 15, 1943.

Agreement Form 873 was executed by the taxpayer.

Schedule 1—1939

Block Adjustments

	R.A.R. 1/27/41	Deductions from income	Corrected
1. Dividends.....	\$ 206.00		
2. Interest.....	322.09		
4. Farm loss.....	(9,521.95)		
6. Business income.....	45,086.85		No change
8. Other income.....	63.82		
10.	<hr/> \$36,156.81		<hr/> \$36,156.81
12. Contributions.....	\$ 294.00		\$ 294.00
13. Interest.....	663.87		663.87
14. Taxes.....	498.08	576.51	1,074.59
16.	<hr/> \$ 1,455.95		<hr/> \$ 2,032.46
17.	34,700.86	576.51	34,124.35

Plaintiff's Exhibit No. 15—(Continued)

Schedule 1-A

Explanation of Items

(14) Taxes:

Additional tax for 1939 was assessed by the State of Oregon, caused through a redistribution of income and expense proratable to business done within and without the State of Oregon for that period. The tax was paid in 1941.

Schedule 2—Year Ended 12/31/39

Computation of Tax

Net income, from Schedule 1	\$34,124.35	
Less: Personal exemption	\$2,500.00	
Credit for dependents	400.00	2,900.00
		<hr/>
Balance (surtax net income)		\$31,224.35
Less: Earned income credit	\$ 901.74	901.74
		<hr/>
Balance subject to normal tax		\$30,322.61
Normal tax at 4%	\$1,212.90	
Surtax on \$31,224.35	3,232.63	
		<hr/>
Total tax		4,445.53
		<hr/>
Total tax assessable		\$ 4,445.53
Tax previously assessed		4,578.12
		<hr/>
Overassessment		\$ 132.59

PLAINTIFF'S EXHIBIT No. 16

No. 15059-O

Treasury Department
Internal Revenue Service

[Printer's Note]: (Pencil Notation): Overassessment 3/9/43, \$163.54.

Seattle, Washington, June 25, 1941

[Stamp]: Ross B. Hammond Co., Received June 26, 1941.

[Stamp]: Paid, Clerk No. 5483. Date 7/11/41.

Seattle Division

Mr. Ross B. Hammond,
1214 Spalding Bldg.,
Portland, Oregon.

In re: Income Tax

Date of Report: June 12, 1941

Year Examined: 1940

Sir:

There is enclosed for your information and files a copy of a report covering the examination of your income tax return for the year indicated, recently made by a representative of this office. You have indicated your agreement to the adjustment of tax liability shown in the report.

The item checked below explains briefly how settlement of the agreed tax liability will be accomplished through the office of the Collector of Internal Revenue for your district.

Respectfully,

/s/ GEO. C. EARLEY,

Internal Revenue Agent in

ENH:AJB

Charge.

Enclosure.

Plaintiff's Exhibit No. 16—(Continued)

Deficiency: The Collector will present to you at an early date a bill for payment of the tax, together with interest, at which time remittance should be made to that official, provided you have not already paid the full amount due.

* * *

Name of taxpayer, Ross B. Hammond.

Date of report, June 12, 1941.

Statement of Total Tax Liability

Income Tax, Year: 1940; Tax Previously Assessed: \$6,534.29; Adjustments Proposed in This Report, Deficiency: \$16.50; Correct Tax Liability, \$6,550.79.

Note.—The amount shown in the first column of the above statement is the amount assessed on the original return, except as indicated in the following summary of adjustments previously made.

* * *

Preliminary Statement

Year 1940

The cause of the additional tax was the claiming of cost of common stock that became worthless in 1934.

The findings have been explained to Mr. Ross B. Hammond, who has signed agreement form 870 herewith.

Plaintiff's Exhibit No. 16—(Continued)

Taxpayer was married and living with wife during the entire taxable year. Taxpayer provided the entire support of his 84-year-old father.

Schedule 1—Year 1940

Block Adjustments

	Return	Additions to Income	Corrected
3. Interest.....	\$ 386.15		\$ 386.15
6. Ranch loss.....	(10,945.87)		(10,945.87)
9. Business.....	47,685.22		47,685.22
10(b). Long term loss.....	(115.00)	50.00	(65.00)
10(c). Loss on sale of equipment.....	(936.90)		(936.90)
12. Total.....	\$36,073.60		\$36,123.60
13. Contributions.....	381.00		381.00
14. Interest.....	513.22		513.22
15. Taxes.....	2,385.83		2,385.83
19.	\$ 3,280.05		\$ 3,280.05
22. Net income	\$ 32,793.55	50.00	\$32,843.55

Schedule 1-A—Year 1940

Explanation of Items

Line 10(b) Net long-term loss decreased . . . \$50.00

Taxpayer purchased capital stock of the Eastmoreland Company in 1929 as follows:

5 Shares of preferred \$250.00

1 Share of common 100.00

Total \$350.00

Plaintiff's Exhibit No. 16—(Continued)

During the year 1934 the bondholders foreclosed on the properties of that corporation, leaving the common stock worthless and a nominal amount to apply on preferred stock.

Taxpayer has received liquidating payments on his preferred stock, the final having been received in 1940. Inasmuch as the common stock became worthless in 1934, its cost is not to be considered in the final liquidation.

Cost of preferred stock 1929.....	\$250.00
Liquidation in 1937	\$75.00
Liquidation in March 1940.....	45.00 120.00
<hr/>	
Loss	\$130.00
50% allowable	65.00

Schedule 2—Year Ended Dec. 31, 1940

Computation of Tax—Internal Revenue Code

1. Net income (from Schedule 1).....	\$32,843.55
2. Less: Personal exemption	\$2,000.00
3. Credit for dependents	400.00 2,400.00
<hr/>	
4. Balance (surtax net income).....	\$30,443.55
5. Less: Earned income credit.....	953.70
<hr/>	
Balance subject to normal tax.....	\$29,489.85
8. Normal tax at 4%	\$1,179.59
9. Surtax	4,773.07
<hr/>	
10(a). Total tax	\$ 5,952.66
10(b). Total tax (alternative tax in case of a net long-term gain or loss) (from Schedule 2-A).....	5,955.26
11. Defense tax (10% of above).....	595.53
12. Total income and defense taxes.....	6,550.79
15. Total tax assessable	6,550.79
16. Tax previously assessed	6,534.29
17. Additional tax to be assessed.....	16.50

Plaintiff's Exhibit No. 16—(Continued)

Schedule 2-A—Year 1940

Alternative Tax Computation

1. Net income, Schedule 1	\$32,843.55
2(b). Add: Long term loss	65.00
3. Ordinary net income	32,908.55
4. Less: Personal exemption	\$2,000.00
5. Credit for dependent	400.00 2,400.00
<hr/>	
6. Surtax net income	\$30,508.55
8. Earned income credit	953.70
9. Normal tax net income.....	29,554.85
Normal tax at 4%	\$ 1,182.19
Surtax on 6 above	4,792.57
Partial tax	5,974.76
30% of 2(b) above	19.50
Alternative tax	5,955.26
Total tax, line 10(a), Schedule 2.....	5,952.66
Tax liability	\$ 5,955.26

PLAINTIFF'S EXHIBIT No. 17

Treasury Department

Internal Revenue Service

Seattle, Washington, March 23, 1943

[Stamp]: Ross B. Hammond Co., Received Mar.
25, 1943.

Seattle Division

Mr. Ross B. Hammond

1214 Spalding Bldg., Portland, Ore.

In re: Income Tax

Date of Report: March 1, 1943

Year(s) Examined: 1940

Sir:

There is enclosed for your information and files
a copy of a report covering the examination of

Plaintiff's Exhibit No. 17—(Continued)

Schedule 2—Year ended 12/31/40

Computation of Tax

Net income, from Schedule 1	\$32,406.30
Less: Personal exemption	\$2,000.00
Credit for dependents	400.00 2,400.00
Balance (surtax net income).....	\$30,006.30
Less: Earned income credit.....	953.70
Balance subject to normal tax.....	\$29,052.60
Normal tax at 4%.....	\$1,162.10
Surtax on \$30,006.30	4,641.89
Total tax	5,803.99
Total tax (alternative tax in case of a net long-term gain or loss)	5,806.59
Defense tax—10%	580.66
Total income and defense taxes.....	\$ 6,387.25
Total tax assessable	6,387.25
Tax previously assessed	6,550.79
Overassessment	\$ 163.54

Schedule 3—Year ended 12/31/40

Computation of Alternative Tax—1938 Act or I.R.C.

Net income, from Schedule 1.....	\$32,406.30
Plus: Net long-term loss	65.00
Ordinary net income	\$32,471.30
Less: Personal exemption	\$2,000.00
Credit for dependents	400.00 2,400.00
Balance (surtax net income).....	\$30,071.30
Less: Earned income credit	953.70

Plaintiff's Exhibit No. 17—(Continued)

Balance subject to normal tax.....	\$29,117.60
Normal tax at 4%	\$1,164.70
Surtax on \$30,071.30	4,661.39
Partial tax	5,826.09
Minus: 30% of net long-term loss	19.50
	<hr/>
Alternative tax	\$ 5,806.59

PLAINTIFF'S EXHIBIT 18

Treasury Department
Internal Revenue Service

Seattle, Washington,
March 23, 1943.

Seattle Division

[Stamp]: Ross B. Hammond Co., Received Mar.
25, 1943.

Mr. Ross B. Hammond
1214 Spalding Building
Portland, Oregon

In re: Income Tax

Date of Report: March 1, 1943

Year(s) Examined: 1941

Sir:

There is enclosed for your information and files a copy of a report covering the examination of your income tax return(s) for the year(s) indicated, recently made by a representative of this office. You have indicated your agreement to the adjustment of tax liability shown in the report.

The item checked below explains briefly how settlement of the agreed tax liability will be accom-

Plaintiff's Exhibit No. 18—(Continued)

plished through the office of the Collector of Internal Revenue for your district.

Respectfully,

/s/ S. R. STOCKTON,

Internal Revenue Agent in Charge.

Enclosure.

* * * *

[x] Deficiency: The Collector will present to you at and early date a bill for payment of the tax, together with interest, at which time remittance should be made to that official, provided you have not already paid the full amount due.

* * * *

Statement of Total Tax Liability

Name of Taxpayer, Ross B. Hammond.

Date of Report: 3/1/1943.

Examining Officer: Keith L. Leslie.

Year: 1941; Liability Tax, \$6,663.03; Previously Assessed*, Tax: \$6,384.09; Adjustments Proposed in This Report, Tax, Deficiency: \$278.94.

* * *

Preliminary Statement

Cause for additional assessment was the disallowance of a deduction for Oregon State excise taxes applicable to years 1939 and 1940.

Credit has been given on account of the inclusion of gain on exchange of automobile, erroneously included as income by the taxpayer.

In the absence of Mr. Hammond, who is in California, the changes were discussed with his bookkeeper and agreement Form 870 is attached hereto.

Plaintiff's Exhibit No. 18—(Continued)

Schedule 1—1941

Block Adjustments

	Return	Additions to income	Deductions from income	Corrected
3. Interest.....	195.69			195.69
8 Net business profit.....	25,066.50		432.61	24,633.89
9. Net farm income.....	2,223.29			2,223.29
			[Penciled] :	26,857.18
<hr/>				
		[Penciled in margin] :		
10.	27,485.48			27,052.87
	[Penciled] :			541.0574
11. Contributions...	350.00			350.00
12. Interest.....	452.47			452.47
13. Taxes.....	2,354.03	1,013.76		1,340.27
<hr/>				
17.	3,156.50			2,142.74
18. Net Income.....	24,328.98	1,013.76	432.61	24,910.13

Schedule 1-A

Explanation of Items

(8) Net business profits: 432.61.

Gain realized on trade-in of automobile on 12/31/41 was erroneously reported as income on line 8. (Detailed in Schedule G of return) Section 19.112(b) (1)-1, Regulations 103 provides for nonrecognition of gain from this type of exchange but the gain realized is used as an offset against the cost of property acquired.

(13) Taxes: Taxpayer, who is on an accrual basis, deducted as a 1941 expense, the state income

Plaintiff's Exhibit No. 18—(Continued)

taxes accruable in the prior year. This resulted in an excess deduction, computed as follows:

Deducted on return, state income tax accruable in 1940....	\$2,065.58
Correct state income tax accruable 1941.....	1,051.82
Excess deduction	<u>\$1,013.76</u>

Schedule 2—Year Ended 12/31/41

Computation of Tax

Net income, from Schedule 1.....	\$24,910.13
Less: Personal exemption	\$1,500.00
Credit for dependents	400.00 1,900.00
Surtax net income	<u>\$23,010.13</u>
Less: Interest on Government obligations.....	545.91
Balance subject to normal tax.....	<u>\$22,464.22</u>
Normal tax at 4%	\$ 898.57
Surtax on \$23,010.13	5,764.46
Total tax	6,663.03
Correct income tax liability	6,663.03
Tax assessed	<u>6,384.09</u>
Deficiency	<u>\$ 278.94</u>

[Penciled]: 25,066.50
2

501.330

[Penciled]: 24910.13
20

498.20260

PLAINTIFF'S EXHIBIT No. 19

Treasury Department
Internal Revenue Service

Seattle 4, Washington,
November 6, 1944.

Seattle Division

[Stamp]: Ross B. Hammond Co., Received Nov.
7, 1944.

Mr. Ross B. Hammond
1241 N. Williams Avenue
Portland, Oregon

Dear Mr. Hammond:

I enclose a copy of the report of the examination of your income tax returns for the years shown below. After consideration by this office, the following adjustment of your tax liability appears to be warranted, for the reasons stated in the report:

Year: 1941; Overassessment, \$6,536.10.

If You Agree to this adjustment, the enclosed form of acceptance should be executed and forwarded to this office promptly, in order that a certificate of overassessment may be issued without unnecessary delay.

If You Do Not Agree to the proposed adjustment, you may file a protest executed in triplicate under oath, with this office, within 30 days from the date of this letter, stating the grounds for your exceptions. Any protest so filed will have careful consideration and, if you so request, an opportunity for a hearing in this office will be granted you. This

Plaintiff's Exhibit No. 19—(Continued)

office will be pleased to answer any questions which may occur to you in your examination of the enclosed copy of the report.

Should you fail to file with this office within the 30-day period mentioned either an acceptance of the adjustment on the enclosed form or a written protest, a recommendation will be made to the Commissioner of Internal Revenue that a certificate of overassessment be issued in the amount stated above.

Your prompt acknowledgment of the receipt of this letter and related papers upon the enclosed form will be much appreciated.

Respectfully,

/s/ S. R. STOCKTON,

Internal Revenue Agent in Charge.

Enclosures:

Report of examination.

Form of acceptance.

Form of acknowledgment.

JAS:MP

Statement of Total Tax Liability

Name of Taxpayer, Ross B. Hammond.

Date of Report, August 29, 1944.

Examining Officer, W. G. Williams.

Index:

Year, 1941: Liability Tax, \$126.93; Previously Assessed*, Tax: \$6,663.03; Adjustments Proposed in This Report, Tax, Overassessment: \$6,536.10.

Plaintiff's Exhibit No. 19—(Continued)

*Summary of Adjustments of Assessments

Year 19..

Originally assessed—No. 519000.....	\$6,384.09
Deficiency assessed, 1943 to Apr. 30.....	278.94
	<hr/>
Net Previous Assessments.....	\$6,663.03

o * *

Preliminary Statement

The overassessment is caused by the improper accrual on the return of Oregon State income taxes.

The taxpayer filed claim for refund on Form 843 based upon an additional accrual of Oregon State income tax. The claim is held allowable. The over-assessment claimed was increased in this report by reason of reallocation of profits derived from construction contracts, a portion of the profits reported for 1941 being held properly taxable for 1942.

The changes made in this report were explained to Mr. Robert T. Jacob, agent for the taxpayer. An Agreement Form was not signed.

The taxpayer was married and living with his wife during the entire year 1941. Credit for dependency was claimed for total support of the taxpayer's aged father, who was physically incapable of self-support.

Plaintiff's Exhibit No. 19—(Continued)

Schedule 1—Year: 1941

Item Adjustments

	Original R.A.R.	Deductions from Income	Corrected
3. Interest.....	\$ 195.69		\$ 195.69
8. Business.....	24,633.89	\$20,448.39	4,185.50
9. Farm income.....	2,223.29		2,223.29
10. Total income.....	\$27,052.87	\$20,448.39	\$ 6,604.48
11. Contributions.....	350.00		350.00
12. Interest.....	452.47		452.47
13. Taxes.....	1,340.27	1,172.43	2,512.70
17. Total deductions.....	\$ 2,142.74	\$ 1,172.43	\$ 3,315.17
22. Net income.....	\$24,910.13	\$21,620.82	\$ 3,289.31

Schedule 1-A—Year 1941

Explanation of Items

Item 8—Business Income

The taxpayer computed business income as follows:

Income from construction contracts	\$49,574.91
Rental of equipment	4,500.00
Interest received	96.14
Discounts taken	1,281.18
Miscellaneous income	309.76
Gain on sale of fixed assets	782.53
	<hr/>
	\$56,544.52
Less: Overhead expenses	31,478.02
	<hr/>
Net income reported from business.....	\$25,066.50
Gain on exchange of automobile held non-taxable in the original RAR	432.61
	<hr/>
Amended net income from business, original RAR.....	\$24,633.89

Plaintiff's Exhibit No. 19—(Continued)

In Exhibit "A", RAR on examination of the 1943 return, the profits from construction—contracts allocable to 1941 are reduced as follows:

Milwaukee Housing Project Job. No. 207:

Profit per books and return.....\$ 7,725.91

Profit as amended 4,728.33

Decrease\$ 2,997.58

Troutdale Aluminum Plant—Job No. 208:

Profit per books and return.....\$23,544.42

Profit as amended 6,093.61

Decrease\$17,450.81

Total decrease of profit reported from construction con-

tracts\$20,448.39

Amended profit from construction contracts.....\$ 4,185.50

Item 13—Taxes

The taxpayer claimed deduction for State of Oregon income tax in the amount of.....\$ 2,065.58

In the original RAR this deduction was decreased by the amount of such taxes accruable for prior years..... 1,013.76

Balance held allowable as a deduction.....\$ 1,051.82

In 1943 the Oregon State Tax Commission audited the taxpayer's 1941 State income tax return, assessing as a result thereof additional 1941 tax of which was paid. The additional tax is held to be a deductible accrual as at December 31, 1941 1,172.43

Allowable deduction for 1941.....\$ 2,244.25

Plaintiff's Exhibit No. 19—(Continued)

Schedule 2

Computation of Tax

1. Net income, from Schedule 1	\$3,289.31
2. Less: Personal exemption	\$1,500.00
Credit for dependents	400.00 1,900.00
3. Surtax net income	\$1,389.31
4. Less: Earned income credit.....	300.00
5. Balance subject to normal tax.....	\$1,089.31
6. Normal tax at 4 percent.....	\$43.75
7. Surtax on item 3.....	83.36
10. Correct income tax liability	126.93
11. Tax assessed	6,663.03
12. Overassessment of income tax	\$6,536.10

District of Oregon.

Acceptance of Proposed Overassessment

The following overassessment or overassessments of tax are hereby accepted as correct:

Taxable year ended, 1941, income tax in the sum of \$6,536.10, amounting to the total sum of \$6,536.10, as indicated in the statement furnished the undersigned taxpayer(s) under date of 10/6/44.

ROSS B. HAMMOND,
Portland, Oregon.

Note: The execution and filing of this acceptance at the address shown in the accompanying letter will expedite the indicated adjustment of your tax liability. This acceptance is not an agreement as

Plaintiff's Exhibit No. 19—(Continued)

provided under section 3760 of the Internal Revenue Code.

If this acceptance is executed with respect to a year for which a Joint Return of a Husband and Wife was filed, it must be signed by both spouses, except that one spouse may sign as the agent for the other.

Where the taxpayer is a corporation, the agreement shall be signed with the corporate name, followed by the signature of such officer or officers of the corporation as are empowered to sign for the corporation, in addition to which the seal of the corporation must be affixed.

PLAINTIFF'S EXHIBIT No. 20

Treasury Department
Internal Revenue Service

Seattle 4, Washington,
November 6, 1944.

[Stamp]: Ross B. Hammond Co., Received, Nov. 7, 1944.

Seattle Division

Mr. Ross B. Hammond
P. O. Box 3901
1241 N. Williams Avenue
Portland, Oregon

Dear Mr. Hammond:

I enclose a copy of the report of the examination of your income-tax returns for the years shown below. After consideration by this office, the fol-

Plaintiff's Exhibit No. 20—(Continued)

lowing adjustment of your tax liability appears to be warranted, for the reasons stated in the report:

Year, 1943; Deficiency, \$145,537.77.

If You Agree to this adjustment, the enclosed form of waiver should be executed and forwarded to this office promptly, in order to permit the early assessment of the additional tax and to stop the accumulation of interest. Such interest will cease 30 days after the receipt of the executed form, or upon the payment of the additional tax to the collector, whichever occurs first.

If you desire to make immediate payment of the additional tax without awaiting assessment, you should forward your remittance to the Collector of Internal Revenue at Portland 9, Oregon, enclosing this letter, or a copy thereof. Interest on the additional tax should be included in your remittance, computed at the rate of 6 per cent per annum from the due date of the first installment to the date of payment.

If You Do Not Agree to the proposed adjustment, you may file a protest, executed in triplicate under oath, with this office, within 30 days from the date of this letter, stating the grounds for your exceptions. Any protest so filed will have careful consideration, and, if you so request, an opportunity for a hearing in this office will be granted you prior to final determination of any deficiency against you. This letter is not a final notice of deficiency, and this office will be pleased to answer any ques-

Plaintiff's Exhibit No. 20—(Continued)

tions which may occur to you in your examination of the enclosed copy of the report.

Should you fail to pay the additional tax to the collector of internal revenue or to file with this office within the 30-day period mentioned either a waiver on the enclosed form or a written protest, final determination of your tax liability will be made and a notice of deficiency will be sent you in accordance with the provisions of law applicable to the assessment and collection of income and profits-tax deficiencies.

Your prompt acknowledgment of the receipt of this letter and related papers upon the enclosed form will be much appreciated.

Respectfully,

/s/ S. R. STOCKTON,
Internal Revenue Agent in
Charge.

Enclosures:

Report of examination.

Form of waiver.

Form of acknowledgment.

JAS:MP

Plaintiff's Exhibit No. 20—(Continued)

Name of Taxpayer, Ross B. Hammond.

Date of Report, August 29, 1944.

Examining Officer, W. G. Williams.

Statement of Total Tax Liability

Index:

Year: 1943; Adjustments Proposed in This Report, Tax, Deficiency: \$145,537.77.

* * *

Preliminary Statement

The cause of the additional tax was an improper computation of profits from construction contracts, and the claim of a partnership status for the taxpayer's business, Ross B. Hammond Company.

The changes made in this report were explained to Mr. Robert T. Jacob, agent for the taxpayer. Agreement Form 870 was not signed by the taxpayer.

The taxpayer was married and living with his wife during the entire period covered by the examination. Credit for dependency of the taxpayer's aged father, physically incapable of self-support.

The taxpayer and his wife, Katherine S. Hammond, filed separate returns. The entire personal exemption was claimed on the return of the taxpayer; none was claimed on the return of his wife.

Plaintiff's Exhibit No. 20—(Continued)

Schedule 1—Year: 1942

Item Adjustments

	Return	Additions to income	Deductions from income	Corrected
3. Interest.....	\$ 91.64			\$ 91.64
6. Farm operation....	(2,688.19)			(2,688.19)
7. Annuities.....	20.04			20.04
8. (a) Sale cap. assets.....	1,751.09		\$2,377.71	(626.62)
(b) Sale other assets.....	(4,755.42)	\$ 4,755.42		
9. Business.....	149,089.15	174,884.99		323,974.14
11. Total income.....	\$143,508.31	\$179,640.41	\$2,377.71	\$320,771.01
12. Contributions.....	900.50			900.50
13. Interest.....	3,881.84	323.61		3,558.23
18. Total deduc.....	\$ 4,842.13	\$ 323.61		\$ 5,418.52
22. Net income.....	\$138,666.18	\$179,964.02	\$2,377.71	\$316,242.49

Schedule 1-A

Explanation of Items

Item 8 (a)—Sale of Capital Assets

During the year 1942 the taxpayer sold at a loss two parcels of real estate which were not used in the taxpayer's trade or business. The loss sustained was claimed in the return at 100% thereof as being sustained by a sale of property, other than capital assets.

The term "capital assets" is defined in the Internal Revenue Code, effective for 1942, as being property held by the taxpayer (whether or not con-

Plaintiff's Exhibit No. 20—(Continued)

nected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the business, of a character which is subject to the allowance for depreciation.**

The real estate sold by the taxpayer does **not** fall within the above-described exceptions and must therefore be held to have been capital assets in the hands of the taxpayer. The deductible loss is computed as follows:

Sale price, less expenses of sale..	\$ 1,389.90
Cost	6,145.32
<hr/>	
Loss sustained on sale.....	\$(4,755.42)
50% deductible, the assets having	
been held more than 6 months	\$(2,377.71)
Long term capital gain reported.	1,751.09
<hr/>	
Net capital loss as amended.....	\$ (626.62)
Net capital gain reported.....	1,751.09
<hr/>	
Reduction of income.....	\$ 2,377.71

Item 8(b)—Sale of Other Than Capital Assets,
\$4,755.42, Transferred to Item 8 (a).

Plaintiff's Exhibit No. 20—(Continued)

Item 9—Income from business.

The taxpayer is engaged in constructing buildings and in other construction work. The business is carried on as a sole proprietorship, operating under the assumed business name, Ross B. Hammond Company. The business was acquired by the taxpayer December 30, 1937, at the dissolution of the corporation, Ross B. Hammond, Inc., of which the taxpayer was the sole stockholder.

The year 1938 was the taxpayer's first year of operation of the business as a sole proprietorship. The taxpayer had the right to elect in that year the accounting method to be used as a basis for reporting the profits derived from long-term construction contracts. The taxpayer's books were kept on the accrual basis. Only one contract was operated in 1938, the construction of the State Capitol Building, Salem, Oregon. Construction under this contract was begun by the corporation and completed in 1939 by the taxpayer. In the taxpayer's 1938 return the profits earned from the contract were reported on the basis of percentage of completion. The computation was made in the return by estimating the total profit to be received from the contract, applying thereto the per cent of completion, as determined by the engineers (98.3), and deducting from the result the profit reported by the corporation. The estimated profit was determined by subtracting from the estimated total income from the contract the expenditures made to December 31, 1938, plus the estimated amount

Plaintiff's Exhibit No. 20—(Continued)

to be paid in 1939. The 1938 profit was computed in the same manner in the taxpayer's books.

For the years 1939, 1940, 1941, 1942, and 1943 the taxpayer made no attempt to keep the books or to prepare the returns upon the basis of percentage of completion. The contract accounts were kept and the returns prepared upon an attempted accrual basis. Proper accruals were not, however, entered in the contract accounts in the books. The income received was not properly accrued; cost of materials, for which the taxpayer was not reimbursed, was not set up as prepaid expense. The lack of proper accrual accounting resulted in a distortion of profits as between the years included in the period of construction.

The question as to whether the taxpayer may change from an established basis for reporting profits derived from long-term constructions contracts to a different basis without first securing the permission of the Commissioner was decided in the case of *Ross B. Hammond, Inc.*, 36 BTA 498, in which it was held that the corporation could not change from the completed contract basis, upon which it had previously filed its returns, to the percentage of completion basis. Upon which the return under examination was filed, without first obtaining such permission.

If permission has been granted the taxpayer to change his basis of accounting, evidence of such permission has not been made available to the examining officer. Regardless of whether such permission was granted, the taxpayer's method of ac-

Plaintiff's Exhibit No. 20—(Continued)

counting does distort the yearly profits. It would be extremely difficult at this time to place the taxpayer's accounts upon a true accrual basis or to determine the per cent of completion of the total of any contract at the close of any of the years under examination. The engineer's estimates show the per cent of completion of each of the many component items specified in the contracts not of the total contract.

Section 41 of the Internal Revenue Code provides: "The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

The distortion of profits must be eliminated in order to more clearly reflect the true income for each of the years under review, and, as neither the true accrual method nor the true percentage of completion method can now be strictly applied, the only recourse to arrive at a proper and proportionate profit is to compute the yearly profit for each contract by applying to the yearly income of each contract the per cent which is the ratio of the total profit derived from the contract to the total income

Plaintiff's Exhibit No. 20—(Continued)

received from the contract. This method had been applied in Exhibit "A," and approximates the method established by the taxpayer in his 1938 return.

Salary of Son:

The taxpayer employed his son, William A. Hammond, in his business operated as Ross B. Hammond Company, paying for his services in 1942 a salary of \$7,500.00. On December 31, 1942, the taxpayer caused a journal entry to be made charging Jobs 208 and 210 with the amount of \$37,129.66, which was credited to Accounts Payable, on behalf of W. A. Hammond. W. A. Hammond had no personal or drawing account in the books. The amount remained in the control accounts payable until December 31, 1943, when the amount was transferred from Accounts Payable to credit of "Ross B. Hammond, Capital." This additional salary was not deducted as an expense in the determination of the net profit from the business used as the basis for division of profits to H. M. Mason and A. V. Petersen. The salary was never paid. In Exhibit "A" the amount of the additional salary, \$37,129.66, is restored to income received from Jobs 208 and 210. The salary paid W. A. Hammond, in the amount of \$7,500.00, is allowed to remain as a deduction in the expenses charged to Jobs 208 and 210.

Plaintiff's Exhibit No. 20—(Continued)

Net profit reported in the return from contracts,		
Exhibit A	\$195,680.63	
Discounts taken	1,515.57	
Profit from Job 204—not listed in Exhibit A.....	127.30	
		<hr/>
		\$197,323.50
Less: Overhead expenses, not allocated		
to contracts	\$ 48,557.96	
Taxes, deducted on line 14 of the return	323.61	\$ 48,234.35
		<hr/>
Amount reported on line 9 of the return.....	\$149,089.15	
Amended contract profit, Exhibit A.....	\$370,889.23	
Add: Discounts taken	1,515.57	
Profit from Job No. 204.....	127.30	
		<hr/>
	\$372,532.10	
Deduct unallocated overhead expense.....	48,557.96	323,974.14
		<hr/>
Increase		\$174,884.99

Item 14—Taxes

Taxes deducted on line 14 of the return, included in the unallocated overhead \$48,557.96, in Item 9, above.

Schedule 2
Computation of Tax

1. Net income, from Schedule 1.....	\$316,252.49	
2. Less: Personal exemption	\$1,200.00	
Credit for dependents.....	350.00	1,550.00
		<hr/>
3. Surtax net income	\$314,702.49	
4. Less: Earned income credit.....		1,400.00
		<hr/>
5. Balance subject to normal tax.....	\$313,302.49	
6. Normal tax at 6 percent.....	\$ 18,798.15	
7. Surtax on item 3.....	233,196.04	
		<hr/>
10. Correct income tax liability.....		\$251,994.19

Plaintiff's Exhibit No. 20—(Continued)

Schedule 3—Year 1943

Adjustments to Net Income

	Income Tax Net Income	Victory Tax Net Income
Net income as disclosed by return.....	\$125,662.41	\$128,086.05
As corrected	78,224.01	80,647.65
Net adjustment as computed below.....	47,438.40	47,438.40
Nontaxable income and additional deductions:		
(1) Business income	\$ 47,438.40	\$ 47,438.40
Net adjustment as above.....	\$ 47,438.40	\$ 47,438.40

Schedule 3-A

Explanation of Items

(1) Business Income

Partnership

At the time the 1943 individual return of Ross B. Hammond was prepared, Mr. Hammond also caused to be prepared and filed partnership returns for the years 1942 and 1943, to conform to a partnership agreement entered into under date of February 3, 1942, by Ross B. Hammond and his son, William A. Hammond. The partnership agreement was predicated upon the sale by Ross B. Hammond to William A. Hammond of one-fourth of the net assets of Ross B. Hammond Company, which, prior thereto, was a sole proprietorship owned by Ross B. Hammond. Partnership profits were to be distributed, 75% to Ross B. Hammond, and 25% to William A. Hammond. Each party was to have an equal voice in the control of the business and operation of the partnership. In payment of

Plaintiff's Exhibit No. 20—(Continued)

one-fourth of the net assets of the business, William A. Hammond gave his note to Ross B. Hammond.

Ross B. Hammond was paid a yearly salary of \$7,500.00, which was charged in the books to the account, "Office Salaries." December 31, 1943, this amount was transferred to "Ross B. Hammond, Drawing." At the close of 1943 the entire profits of the business were credited to the account, "Ross B. Hammond, Capital."

The individual returns of Ross B. Hammond and William A. Hammond, prepared for 1943, each reported their distributive shares of partnership profits.

The books of the sole proprietorship were continued without change in accounting. The drawing account and capital account remained under the name of Ross B. Hammond. No personal, drawing or capital accounts were set up for William A. Hammond.

Under date of February 3, 1942, Ross B. Hammond entered into agreements with H. M. Mason and A. V. Petersen, whereby Mason and Petersen were to participate in the profits of Ross B. Hammond Company in the ratio of 20% in the case of Mason and 15% in the case of Petersen. These agreements were entered into by Ross B. Hammond as an individual.

The salary of William A. Hammond, \$7,500, was deducted as an expense of the business to determine the profits upon which were based the participations of Mason and Petersen. This salary was considered

Plaintiff's Exhibit No. 20—(Continued)

adequate compensation for the services of William A. Hammond and William A. Hammond was withheld from both Mason and Petersen.

The agencies of the United States, with which Ross B. Hammond executed construction contracts, were not informed of the partnership status of Ross B. Hammond Company. Ross B. Hammond represented to these agencies, by affidavit, that he was an individual operating under the name and style of Ross B. Hammond Company. Such representations were also made to all other parties with whom Ross B. Hammond executed construction contracts or had other business relations.

Ross B. Hammond represented to the officials of the United States National Bank of Portland, Oregon, from whom he borrowed large sums of money for use in his construction contracts, that he owned all the assets of Ross B. Hammond Company. He made no representations to the bank that Ross B. Hammond was being operated as a partnership.

The bonds required of Ross B. Hammond in the execution of his construction contracts were executed by the General Casualty Company of America. Ross B. Hammond represented to the bonding company that the assets of Ross B. Hammond Company were owned solely by him.

Subsequent to February 3, 1942, Ross B. Hammond purchased securities, in his own name, with funds of Ross B. Hammond Company. In January, 1943 Ross B. Hammond purchased a tract of real

Plaintiff's Exhibit No. 20—(Continued)

estate with a building thereon, at 1241 N. Williams Avenue, Portland, Oregon, the site of the present office of Ross B. Hammond Company. This purchase was made with funds of Ross B. Hammond Company. Title was passed to Ross B. Hammond.

On January 4, 1937, Ross B. Hammond filed an assumed business name certificate with the clerk of Multnomah County, Oregon, making affidavit that he had the sole interest in or the sole operator of the business of Ross B. Hammond Company. An assumed business name certificate showing the true owners and operators of the business of Ross B. Hammond Company to be Ross B. Hammond and William A. Hammond was never filed with the clerk of Multnomah County, as required by Section 43-504 of the Oregon statutes whenever a change in ownership occurs in any business operating under an assumed business name.

The checking account of Ross B. Hammond Company was kept in the United States National Bank, a separate account being kept for each of the construction contracts. Checks on these accounts were signed: "Ross B. Hammond Company, by" Ross B. Hammond, or, by any two joint signatures of W. A. Hammond, H. M. Mason, A. V. Petersen and Rosalie Novak. Thus, W. A. Hammond was given no more authority to draw on the funds of the business than was granted to the other employees mentioned.

It is held in this report that the partnership existed only in form, not in fact. Ross B. Hammond represented to all his creditors; to the bond-

Plaintiff's Exhibit No. 20—(Continued)

ing company; to the bank; to all agencies and persons with whom he did business; and to his employees that Ross B. Hammond Company was a sole proprietorship and he, Ross B. Hammond, owned all its assets. Ross B. Hammond retained sole control of the business. W. A. Hammond was not permitted to exercise any control as a part owner of the business. W. A. Hammond contributed no capital to the business. The services contributed to the business by W. A. Hammond were adequately compensated for by the salary paid him.

It is held that all the profits of the business, except for the distribution to Mason and Petersen, are taxable to Ross B. Hammond in his individual return.

The business income as amended is computed as follows:

Profits from construction contracts, reported on partnership return,

Exhibit "A"	\$211,306.11	
Rental of equipment	\$2,965.80	
Interest received	2,755.59	
Discounts taken	1,135.12	6,856.51
		<hr/>
		\$218,162.62
Less unallocated overhead expense:		
Salaries and wages	\$12,269.52	
Repairs	1,140.07	
Interest paid	3,142.46	
Taxes	1,338.94	
Depreciation	3,312.16	
Other deductions	20,779.08	41,982.23
		<hr/>
Partnership net income.....	\$176,180.39	
		<hr/>

Plaintiff's Exhibit No. 20—(Continued)

75% claimed distributable to Ross B. Hammond.....	\$132,135.29	
Amended profits from contracts, Exhibit "A".....	\$127,322.61	
Add: Other income, detailed above.....	6,856.51	
		<hr/>
		\$134,179.12
Deduct: Unallocated overhead expense.....	\$41,982.23	
Salary of W. A. Hammond, considered allow- able, not deducted in the partnership re- turn	7,500.00	49,482.23
		<hr/>
Business net income as amended.....	\$	84,696.89
Amount reported		132,125.29
		<hr/>
Decrease	\$	47,438.40

Schedule 4—Year: 1943'

Computation of Income and Victory Tax

1. Income tax net income, from Schedule 1.....	\$	78,224.01
2. Less: Personal exemption	\$	1,200.00
Credit for dependents	350.00	1,550.00
		<hr/>
3. Surtax net income	\$	76,674.01
4. Less: Earned income credit		1,400.00
		<hr/>
5. Balance subject to normal tax.....	\$	75,274.01
6. Normal tax at 6 percent.....	\$	4,516.44
7. Surtax on item 3.....	41,545.29	
		<hr/>
8. Total income tax (item 6 plus item 7) or.....		46,061.73
		<hr/>
Total alternative tax, Schedule 3.....	\$	46,047.73
		<hr/>
10. Balance of Income Tax.....	\$	46,047.73
11. Victory tax net income.....	\$80,647.65	
12. Less: Specific exemption.....	624.00	
13. Income subject to Victory tax.....	80,023.65	
		<hr/>

Plaintiff's Exhibit No. 20—(Continued)

14. Victory tax before credit (5 percent of line 13)	\$ 4,001.18
15. Less: Victory tax credit.....	600.00
	<hr/>
16. Net victory tax	3,401.18
17. Net income tax and victory tax.....	49,448.91
	<hr/>
18. Income tax for 1942, Schedule 2.....	\$251,994.19
	<hr/>
19. Amount of item 17 or 18 whichever is larger.....	\$251,994.19
20. Forgiveness feature (not to be used if either item 17 or 18 is \$50 or less) :	
(a) Amount of item 17 or 18 which- ever is smaller.....	\$49,448.91
(b) Amount forgiven (\$50 or $\frac{3}{4}$ of (a) whichever is larger).....	37,086.68
(c) Amount unforgiven	12,362.23
	<hr/>
21. Total income and victory tax liability.....	\$264,356.42
22. Income and victory tax liability disclosed by return	118,818.65
23. Deficiency in income and victory tax.....	145,537.77

Schedule 5

Computation of Alternative Tax

Long term capital gain:	
Real estate b.o.f. 9/18/42 for.....	\$ 4,200.00
Sold 9/3/43 for.....	4,300.00
	<hr/>
Long term capital gain.....	\$ 100.00
	<hr/>
Taxable gain, 50% of \$100.00.....	\$ 50.00
	<hr/>
Net income, Schedule 1	\$78,224.01
Long term capital gain.....	50.00
	<hr/>
Ordinary net income	\$78,174.01
Personal exemption	\$1,200.00
Credit for dependents	350.00
	<hr/>
Balance, surtax net income	\$76,624.01
Earned income credit	1,400.00
	<hr/>

Balance subject to normal tax.....	\$75,224.01
Normal tax, 6% of \$75,224.01.....	\$ 41,513.44
Surtax	41,509.29
Partial tax	\$46,022.73
50% of \$50.00	25.00
Alternative tax	\$46,047.73

Plaintiff's Exhibit No. 20—(Continued)

Schedule 6—Year: 1943

Modified Exhibit D

	Shown by Return	As Corrected
1. Total income and victory tax liability	\$118,818.65	\$264,356.42
Less:		
(a) Income and victory tax withheld by employer	None	
(b) Income tax paid on 1942 income	\$47,995.94	
(c) Tax paid on 1943 in- come on account of de- claration of estimated tax	56,310.76	104,306.70
Less: Previously allowed		\$118,818.65
3. Deficiency in income and victory tax.....		\$145,537.77

Allocation of Profits from Construction Contracts

MILWAUKEE HOUSING PROJECT—Job No. 207:		1911	1912	1913	Total
Income per books.....		\$ 36,517.28	\$ 215,018.89	\$ 7,634.09	\$ 289,200.76
Costs charged to accounts:					
Labor.....		\$ 6,624.34	\$ 12,961.32		\$ 49,585.66
Material.....		22,197.53	179,127.40	\$ 575.12	202,200.05
Total costs.....		\$ 28,821.87	\$ 222,388.72	\$ 575.12	\$ 251,785.71
Net profits per books.....		\$ 7,725.91	\$ 22,630.17	\$ 7,058.97	\$ 37,415.05
Accruing 1913 sales and costs at 12/31/12:					
Transfer of income to 1913.....			\$ 7,634.09		
Amended sales.....		\$ 36,517.78	\$ 252,652.98		\$ 289,200.76
Per cent of total profit to total income:					
37,415.05/289,200.76, or 12.93797%—Allocating total					
profit to the years in proportion to the yearly income,					
12.93797% of income.....					
Profit reported.....		\$ 4,728.33	\$ 32,686.72		\$ 37,415.05
		7,725.91	22,630.17	\$ 7,058.97	37,415.05
Increase (decrease).....		\$ (2,997.58)	\$ 10,056.55	\$ (7,058.97)	
TROUTDALE ALUMINUM PLANT—Job No. 208:					
Income received.....		\$ 59,775.31	\$ 1,036,623.10	\$ 274,131.59	\$ 1,370,830.00
Costs charged to account:					
Labor.....		\$ 6,851.77	\$ 359,907.16	\$ 67,565.87	\$ 434,327.80
Material.....		29,376.12	697,502.67	112,929.10	839,807.89
Total costs.....		\$ 36,230.89	\$ 1,057,409.83	\$ 180,494.97	\$ 1,274,135.69
Profit per books.....		\$ 23,544.42	\$ (20,786.73)	\$ 93,936.62	\$ 96,691.31
TROUTDALE ALUMINUM PLANT—Job No. 208-A:					
Income received.....			\$ 200,661.74	\$ 34,971.17	\$ 235,632.91
Costs charged to account:					
Labor.....			\$ 75,856.12		\$ 75,856.12
Material.....			85,094.98	\$ 16,892.61	101,987.59
Total costs.....			\$ 160,951.10	\$ 16,892.61	\$ 177,843.71
Profit per books.....			\$ 39,710.64	\$ 18,078.56	\$ 57,789.20
In the returns the sales, costs, and profits from Jobs 208 and 208-A were consolidated for the stated reason that the work performed for the same agency in both contracts and the labor and material costs were not properly allocated to each contract.					
TROUTDALE ALUMINUM PLANT—					
Consolidating Job Nos. 208-208-A:					
Income received.....		1911	1912	1913	Total
		\$ 59,775.31	\$ 1,237,284.84	\$ 309,402.76	\$ 1,606,462.91
Costs charged to account:					
Labor.....		\$ 6,851.77	\$ 435,763.28	\$ 67,565.87	\$ 510,183.92
Material.....		29,376.12	782,597.65	129,821.71	911,795.48
Total costs.....		\$ 36,230.89	\$ 1,218,360.93	\$ 197,387.58	\$ 1,451,979.10
Profit per books.....		\$ 23,544.42	\$ 18,923.91	\$ 112,015.18	\$ 151,183.51
Restoring to profit the deduction of salary credited to W. A. Hammond in excess of \$7,500.00, 1/4 of which was allocated to this contract:					
Salary deducted.....					\$11,157.41
Less: 25% of \$7,500.00, allowable.....			9,282.41		9,282.41
					1,875.00

Exhibit A—(Continued)

Amended Net Profit.....	1941	1942	1943	Total
Percent of total profit to total income: 163,765.92/1,606,162.91, or, 10.194192%. Allocation of total profit to years, in proportion to the yearly income: 9,282.41/163,765.92, or 10.194192%, 10.194192% of yearly income.....	\$ 23,544.42	\$ 28,206.32	\$ 112,015.18	\$ 163,765.92
Profits reported.....	\$ 6,093.61 23,544.42	\$ 126,131.20 18,923.91	\$ 31,541.11 112,015.18	\$ 163,765.92 154,483.51
Increase (Decrease).....	\$ (17,450.81)	\$ 107,207.29	\$ (80,474.07)	\$ 9,282.41

BONNEVILLE CONTROL HOUSE—Job No. 209:

Income received.....	\$ 42,853.14
Costs charged to account:	
Labor.....	\$ 4,328.55
Material.....	32,120.99
Total costs.....	\$ 36,449.54
Profit reported.....	\$ 6,408.60

The income costs and net profit from this contract were consolidated with the figures of Jobs 208 and 208-A and the consolidated figures reported as Job 208 in the 1942 return. While this contract was performed on the site of the Aluminum Plant contract, the contract was executed as a separate construction project from Job 208, and the profits therefrom are treated herein as separate and apart from those derived from Jobs 208 and 208-A.

GULDS LAKE—Job No. 210:

42 [Penciled figures] 13

Income received.....	\$ 1,072,360.85	\$ 29,155.98	\$ 1,101,516.83
Costs charged to accounts:			
Labor.....	\$ 139,912.26	\$ 1,170.00	\$ 141,082.26
Material.....	817,698.31	3,220.13	820,918.44
Total costs.....	\$ 957,610.57	\$ 4,390.13	\$ 962,000.70
Profit reported.....	\$ 114,750.28	\$ 21,765.85	\$ 139,516.13
Restoring to profit the deduction of salary credited to W. A. Hammond in excess of \$7,500.00, $\frac{3}{4}$ of which was allocated to this contract:			
Salary deducted.....	\$ 33,472.25		
Less: 75% of \$7,500.00, allowable.....	5,025.00	27,847.25	27,847.25
Amended profits.....	\$ 142,597.53	\$ 24,765.85	\$ 167,363.38

Allocation of total profit to years in proportion to the

yearly income:				
167,363.38/1,101,516.83, or, 15.193901% of yearly income				
Profit reported	\$ 162,933.45	\$ 4,429.93	\$ 167,363.38	
	114,750.28	24,765.85	139,516.13	
Increase (decrease).....	\$ 48,183.17	\$ (20,335.92)	\$ 27,847.25	

UNIVERSITY HOMES HOUSING PROJECT

Job No. 211 (cost-plus):

Income received.....	\$ 72,638.48	\$ 73,007.75	\$ 145,716.23
Less: Superintendence charged.....	39,670.81	20,328.51	59,999.32
Profit reported.....	\$ 32,967.67	\$ 52,749.24	\$ 85,716.91
Allocation of total profit: 85,716.91/145,716.23, or 58.824545% of yearly income.	42,729.26	42,987.65	85,716.91
Increase (decrease).....	\$ 9,761.59	\$ (9,761.59)	

Plaintiff's Exhibit No. 20—(Continued)

Exhibit A—(Continued)

COLUMBIA STEEL CASTING

PLANT—Job No. 213:	1943	1944	Total
Income received	\$375,430.50	\$ 35,139.81	\$410,570.31
<hr/>			
Costs charged to account:			
Labor	\$ 52,691.89	\$ 2,243.85	\$ 54,935.74
Material	312,578.85	5,285.45	317,864.30
<hr/>			
Total costs	\$365,270.74	\$ 7,529.30	\$372,800.04
<hr/>			
Net profit reported.....	\$ 10,159.76	\$ 27,610.51	\$ 37,770.27
Estimated additional equip- ment rental .....	.....	1,100.00	1,100.00
<hr/>			
Amended profit	\$ 10,159.76	\$ 28,710.51	\$ 38,870.27
Allocation of total profit: 38,870.27/411,670.31, or 9.4420875% of yearly in- come	35,448.48	3,421.79	38,870.27
<hr/>			
Increase (Decrease)	\$ 25,288.72	(\$25,288.72)	

OREGON WOODWORKING

Job No. 214:

Income received	\$ 3,146.51
<hr/>	
Costs charged to account	
Labor	\$ 1,781.60
Material	1,078.86
<hr/>	
Total costs	\$ 2,860.46
<hr/>	
Net profit reported— not changed	\$ 286.05

NORTHWESTERN ICE COM-

PANY PLANT—Job No. 215:

Income received	\$ 51,583.98	\$ 15,198.59	\$ 66,782.57
<hr/>		<hr/>	<hr/>

Plaintiff's Exhibit No. 20—(Continued)

Exhibit A—(Continued)

Costs charged to account:	1943	1944	Total
Labor	\$ 44,793.07	\$ 7,375.69	\$ 52,168.76
Material	6,790.91	2,053.57	8,844.48
Total cost	\$ 51,583.98	\$ 9,429.26	\$ 61,013.24
Net profit reported	None	\$ 5,769.33	\$ 5,769.33
Allocation of total profit to years in proportion to the yearly income: 5,769.33/66,782.57, or 8.6389757%	\$ 4,456.33	1,313.00	5,769.33
Increase (Decrease)	\$ 4,456.33	\$ (4,456.33)	

CORNELUS FLAX PLANT

Job No. 216:

Income reported	\$ 99,373.53	\$ 2,626.00	\$101,999.53
Costs charged to account:			
Labor	\$ 38,504.98	\$ 375.30	\$ 38,880.28
Material	62,809.91	1,432.15	64,242.06
Total costs	\$101,314.89	\$ 1,807.45	\$103,122.34
Net profit reported.....	\$ (1,941.36)	\$ 818.55	\$ (1,122.81)
Allocation of total net loss to years in proportion to yearly income: 1,122.81/101,999.53, or 1.1007991%	\$ (1,093.90)	\$ (28.91)	\$ 1,122.81
Increase (Decrease)	\$ 847.46	\$ (847.46)	

KAISER RESERVE WARE-

HOUSE—Job No. 217:

Income received	\$ 87,300.25	\$110,397.75	\$197,698.00
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Plaintiff's Exhibit No. 20—(Continued)

Exhibit A—(Continued)

Costs charged to account:	1943	1944	Total
Labor	\$ 20,751.44	\$ 24,183.24	\$ 44,934.68
Material	63,133.95	70,436.57	133,570.52
Total costs	\$ 83,885.39	\$ 94,619.81	\$178,505.20
Net profit reported.....	\$ 3,414.86	\$ 15,777.94	\$ 19,192.80
Allocation of total profit to years in proportion to yearly income: 19,192.80/197,698.00, or 9.7081407	8,475.23	10,717.57	19,192.80
Increase (Decrease)	\$ 5,060.37	\$ (5,060.37)	

NEGRO PERSONAL SERVICE
BUILDING—Job No. 220

Income received	\$ 7,559.00	\$ 7,283.00	\$ 14,842.00
Costs charged to account:			
Labor	\$ 2,082.56	\$ 1,461.75	\$ 3,544.31
Material	2,678.88	7,064.25	9,743.13
Total cost	\$ 4,761.44	\$ 8,526.00	\$ 13,287.44
Net profit reported.....	\$ 2,797.56	\$ (1,243.00)	\$ 1,554.56
Allocation of total profit to years in proportion to yearly income: 1,554.56/14,842.00, or 10.47406%	791.73	762.83	
Increase (Decrease)	\$ (2,005.83)	\$ 2,005.83	

Plaintiff's Exhibit No. 20—(Continued)

Exhibit A—(Continued)

[illegible]

Plaintiff's Exhibit No. 20—(Continued)

EXHIBIT B

Analysis of Capital Account

	Dr.	Cr.	Balance
12/31/40 Balance			\$18,138.19
12/31/40 Drawings	\$28,508.67		
12/31/41 1941 profits		\$25,066.50	
12/31/41 Balance			14,696.02
12/31/42 Drawings	8,451.17		
12/31/42 1942 profits		148,765.54	
12/31/42 Balance			155,010.39
12/31/43 Trf. credit from accts. pay—1942		37,129.66	
12/31/43 1942 drawings R.B.H. restored		8,451.17	
12/31/43 1943 profits		176,180.39	
			376,771.61
12/31/43 R. B. Hammond, Draw- ing—not closed at 12/31/43 to R. B. Hammond, capital 127,054.01			
12/31/43 Actual balance			249,717.60

Schedule A.—INTEREST ON GOVERNMENT OBLIGATIONS, ETC. (See Instruction 5)

Page 2

1. Obligations or securities	2. Amount owned at end of year including your proportionate share of such obligations held by estate, trust, partnership, or common trust funds	3. Interest received or accrued during the year	4. Amount of principal interest on which is exempt from taxation	5. Interest on amount in excess of exemption, and dividends subject to surtax only
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	\$	\$	All	XXXXXX
(b) Obligations issued prior to March 1, 1941, under Federal Farm Loan Act, or under such Act as amended			All	XXXXXX
(c) Obligations of United States issued on or before September 1, 1917			All	XXXXXX
(d) Treasury Notes issued prior to December 1, 1940, Treasury Bills and Treasury Certificates of Indebtedness issued prior to March 1, 1941			All	XXXXXX
(e) United States Savings Bonds and Treasury Bonds issued prior to March 1, 1941			\$5,000	\$
(f) Obligations of instrumentalities of the United States (other than obligations to be reported in (b) above) issued prior to March 1, 1941			None	
(g) Dividends on share accounts in Federal savings and loan associations in case of shares issued prior to March 28, 1942	XXXXXXXXXX	XX XXXXXXXX	XX	XX
(h) Total (enter as item 5 (e), page 1)				\$

(i) Treasury Notes issued on or after December 1, 1940, and obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof (enter amount of interest as item 5 (b), page 1) \$

Amount owned at end of year \$

Interest received or accrued during the year (subject to normal tax and surtax) \$

Schedule B.—INCOME FROM RENTS AND ROYALTIES. (See Instruction 6)

1. Kind of property	2. Amount	3. Depreciation or depletion (attach schedule)	4. Repairs (explain below)	5. Other expenses (itemize below)	6. Net profit (column 2 minus sum of columns 3, 4, and 5) (enter as item 6, page 1)
	\$	\$	\$	\$	\$

Explanation of deductions claimed in column 4 and 5

Schedule C.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 12, 13, 14, 15, 16, AND 17

1. Item No.	2. Explanation	3. Amount	4. Item No. (Continued)	5. Explanation (Continued)	6. Amount (Continued)
12	Fed. Cross & Overseas News Fund	4500	19	State Income Tax	2912
13	Helfgott & Pendergast Tax Co.	29953	19	Telephone Service & Sales	573
14	Auto & used car tax	1250	19	Gasoline Tax	1370
14	Property Taxes	11973	15	Tractor car motor	5120

Schedule D.—EXPLANATION OF CREDITS CLAIMED IN ITEMS 21 AND 22. (See Instructions 21 and 22)

(1) Personal Exemption			(2) Credit for Dependents		
Status	Number of months during the year in each status	Credit claimed	Name of dependent and relationship	Number of months during the year	Credit claimed
				Under 18 years old	18 years or over
Single, or married not living with husband or wife, and not head of family		\$	Harry Ross	12	\$ 350.00
Married and living with husband or wife	12	1200.00			
Head of family (explain below)					
			Reason for support if 18 years or over		

Schedule E.—COMPUTATION OF EARNED INCOME CREDIT. (See Instruction 25)

(1) If your net income is \$3,000 or less, use only this part of schedule	(2) If your net income is more than \$3,000, use only this part of schedule
Net income (item 19, page 1) \$	Earned net income (not more than \$14,000) \$ 7500.00
Earned income credit (10% of net income, above)	Net income (item 19, page 1) 7000.00
	Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but not enter less than \$300) 700.00

QUESTIONS

1. Did you file a return for any prior year? Yes If so, what was the latest year? 1941 To which Collector's office was it sent? Portland, Oregon

as made for the current year, state:

and or wife

tion, if any, claimed thereon

e to which it was sent

turn was prepared on the cash ✓ or accrual basis

4. Was the rate of your salary or wages increased or decreased after October 3, 1942, and before the end of your taxable year? No (Yes or No)

5. Did you receive during your taxable year any amount claimed to be non-taxable other than H)? No amount of such income

6. Did you at any time during the year own any stock of a foreign corporation (other than a foreign corporation owned by a partnership in which you are not a partner) which was not listed on the statement required by section 501(c)(2)?

UNITED STATES
INDIVIDUAL INCOME AND VICTORY TAX RETURN

Page 1
1943

OPTIONAL FORM 1040A MAY BE FILED INSTEAD OF THIS FORM IF GROSS INCOME IS REPORTED ON THE CASH BASIS FOR THE CALENDAR YEAR, IS NOT MORE THAN \$5,000, AND CONSISTS WHOLLY OF SALARY, WAGES, OTHER COMPENSATION FOR PERSONAL SERVICES, DIVIDENDS, INTEREST OR ANNUITIES

FOR CALENDAR YEAR 1943

or fiscal year beginning _____, 1943, and ending _____, 1944

PRINT NAME AND ADDRESS PLAINLY. (See Instructions C)

ALFRED V. PETERSEN

(Please) (Use given names of both husband and wife, if this is a joint return)

624 S. E. 52nd Avenue

(Street and number, or rural route)

Portland 15,

Oregon

(City or town)

(State)

Occupation Const. Supt.

Social Security number, if any 540-03-9006

(Do not use space)
File No. 908563

Serial No.

Oregon

WITH AFFIDAVIT

COMPUTATION OF NET INCOME

INCOME		Column 1 Income Tax Net Income	Column 2 Victory Tax Net Income
1. Salary, Wages, and Compensation (See Instructions A and B)	Employer's Name Ross B. Hammond Co.	\$ 7,500.00	\$ 7,500.00
2. Dividends	City and State Portland 8, Oregon		
3. Interest on corporation bonds, bank deposits, notes, etc.			
4. Interest on Government obligations, etc.: (a) From line A (8), Schedule A (b) From line B (5) and (3), Schedule A			
5. Annuities			
6. (a) Net gain (or loss) from sale or exchange of capital assets. (From Schedule B) (b) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule B)			
7. Rents and royalties. (From Schedule C (1))			
8. Net profit (or loss) from business or profession. (From Schedule C (2)) (State total receipts, from line 1, Schedule C (2) \$ _____)			
9. Income (or loss) from partnerships; fiduciary income; and other income. (From Schedule C (3))			
10. Total income in items 1 to 9		\$ 7,515.32	\$ 7,515.32
DEDUCTIONS			
11. Contributions. (Explain in Schedule D)		\$ 27.00	XXXXXX XX
12. Interest. (Explain in Schedule E) (See Instructions 12 and 16 for Victory Tax deductions)		217.54	XXXXXX XX
13. TAXES. (Explain in Schedule F) (See Instructions 13 and 16 for Victory Tax deductions)		403.49	XXXXXX XX
14. Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule G)		86.20	XXXXXX XX
15. Medical, dental, etc., expenses. (Explain in Schedule H)			XXXXXX XX
16. Other deductions authorized by law. (Explain in Schedule I)			XXXXXX XX
17. Total deductions in items 11 to 16		\$ 734.23	\$ 734.23
18. Income Tax net income (item 10, col. 1, less item 17, col. 1)		\$ 6,780.99	XXXXXX XX
19. Victory Tax net income (item 10, col. 2, less item 17, col. 2)		XXXXXX XX	\$ 7,515.32

INCOME AND VICTORY TAX

20. Unpaid balance of 1943 Income and Victory Tax (from line 22, page 4)	\$ 32.13
21. You may postpone, until not later than March 15, 1945, payment of the amount you owe up to one-half of item 19 (c), page 4. Enter the amount postponed. (For persons whose surtax net income for 1942 or 1943 exceeded \$20,000, see Schedule L-2)	
22. Amount paid with this return (item 20 less item 21)	\$ 32.13
23. Refund or Credit	
If the total of your payments (line 21 (d) on page 4) is larger than your tax (line 20 on page 4), enter the difference. Indicate by a check mark (✓) what you want done with this overpayment: Refund it to me <input type="checkbox"/> . Apply it on my 1944 estimated tax <input type="checkbox"/> .	

I declare under the penalties of perjury that this return (including any accompanying schedule and statement) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Signature of person (other than taxpayer or agent) preparing return (Date) Signature of taxpayer (Date)

1. Name and Address of Organization	2. Amount	3. To Whom Paid	2. Amount
Portland United War Chest	\$ 15.00	Prudential Insurance Co.	\$ 213.01
Infantile Paralysis Fund	7.00	Metropolitan Insurance Co.	4 63
Tuberculosis Fund	5.00		
Total (Enter as item 11, page 1, subject to 15% limitation).	\$ 27.00	Total (Enter as item 12, page 1)	\$ 217.64

Schedule F.—TAXES. (See instruction 13)

Schedule C.—LOSSES AND OTHER DEDUCTIONS. (See Instructions 14 and 15)

1. Nature	2. Amount	3. Item No.	4. Explanation	5. Amount
Motor Vehicle Tax & License	10.00	14	Overcoat stolen	35.00
Telephone & Telegraph	7.93	14	Frozen motor on vehicle	51.20
State Income Tax	253.76			86.20
Property Taxes	131.80			
Total (Enter as item 13, page 1).	403.49			

Schedule H—MEDICAL, DENTAL, ETC., EXPENSES. (See Instruction 15)

[illegible]

Schedule I.—PERSONAL EXEMPTION AND CREDIT FOR DEPENDENTS. (See Tax Computation Instructions)

(1) Personal Exemption			(2) Credit for Dependents			
Status	Number of months during the year in each status	Credit claimed	Name of dependent and relationship	Number of months during the year:		Credit claimed <small>(Head of a family may not claim credit for dependent ward to qualify as head of a family.)</small>
				Under 18 years of age	18 years or over	
Single, or married and not living with husband or wife, and not head of family.....	12	\$ 1,200 00	Son	12		\$ 350 00
Married and living with husband or wife.....						
Head of a family (explain below).....						
			Reason for support if 18 years or over.....			

Schedule J.—COMPUTATION OF EARNED INCOME CREDIT. (See Tax Computation Instructions)

(1) If your net income is \$3,000 or LESS, use only this part of schedule		(2) If your net income is MORE than \$3,000, use only this part of schedule	
Net income (item 18, page 1).....	\$.....	Earned net income (not more than \$14,000).....	\$..... 7,500.00
Earned income credit (10% of net income, above).....		Net income (item 18, page 1).....	6,780.99
		Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but do not enter less than \$300).....	678.10

QUESTIONS

1. Did you file a return for any prior year? YES..... If so, what was the latest year? 1942. To which Collector's office was it sent? Same
2. If you claimed credit for tax paid in line 21 (c), page 4, to which Collector's office was your declaration sent? Same
3. If separate return was made for the current year, state:
- (a) Name of husband or wife
- (b) Personal exemption, if any, claimed thereon
- (c) Collector's office to which was sent
4. Check whether this return was prepared on the cash ☒ or accrual ☐ basis.
5. Was the rate of your salary or wages increased or decreased during your taxable year? (Yes or No) NO
6. Did you receive during your taxable year any amount claimed to be non-taxable (see General Instruction 1)? NO. If so, attach schedule showing source, nature, and amount of such income.
7. Did you at any time during your taxable year own directly or indirectly any stock of a foreign corporation, or a personal holding company as defined by section 501 of the Internal Revenue Code? NO. If so, attach statement required by General Instruction L.

COMPUTATION OF INCOME AND VICTORY TAX. (See Tax Computation Instructions)

Page 4

1. Income Tax net income (item 18, page 1)		\$ 6,780.99
2. Less: Personal exemption. (From Schedule L-1)	\$ 1,200.00	
3. Credit for dependents. (From Schedule L-2)	350.00	1,550.00
4. Balance (surtax net income)		\$ 5,230.99
5. Less: Certain interest on Government obligations (item 4 (a), page 1)		
6. Earned income credit. (From Schedule J-1) or J-2	678.10	678.10
7. Balance subject to normal tax		\$ 4,552.89
8. Normal tax (6% of line 7)		\$ 273.17
9. Surtax on amount in line 4. (See Surtax Table, page 3 of Instructions)		826.20
10. Total Income Tax (line 8 plus line 9). (If Schedule B is used and alternative tax computation made, enter line 16, Schedule B)		\$ 1,099.37
11. Less: Income Tax paid to a foreign country or U. S. possession. (Attach Form 1114)		
12. BALANCE OF INCOME TAX		\$ 1,099.37
13. NET VICTORY TAX (line 6 of Victory Tax Schedule, below)		199.85
14. Total of lines 12 and 13		\$ 1,299.22
15. Income Tax paid at source on tax-free covenant bond interest. (See Footnote 1)		
16. Line 14 less line 15		\$ 1,299.22
17. Income Tax for 1942. (See Statement, Form 1125, from Collector) (First, see page 4 of Instructions)		\$ 1,157.16
18. Enter line 16 or 17 whichever is LARGER. (Members of the armed forces see page 4 of Instructions)		\$ 1,299.22
19. FORGIVENESS FEATURE (Don't fill in (a), (b), and (c) below, if either line 16 or 17 is \$50 or less):		
(a) Enter line 16 or 17, whichever is SMALLER	\$ 1,157.16	
(b) Enter \$50 or three-fourths of (a), immediately above, whichever is LARGER. This is the FORGIVEN part of the tax	\$ 867.87	
(c) Enter the UNFORGIVEN part of the tax which is the BALANCE (subtract (b) from (a)). (See Footnote 2)		289.29
20. TOTAL INCOME AND VICTORY TAX. (Total of lines 18 and 19 (c))		\$ 1,588.51
21. Less: (a) Income and Victory Tax withheld by employer	\$ 977.80	
(b) Income Tax paid on 1942 income	5.78	58
(c) Tax paid on 1943 income on account of Declaration of Estimated Tax		
(d) Total payments		1,556.38
22. UNPAID BALANCE OF INCOME AND VICTORY TAX. (If line 20 is larger than line 21 (d), enter the difference here and also as item 20, page 1; if not, see item 23, page 1)		\$ 32.13

FOOTNOTE 1.—If you claim a credit in line 15, disregard lines 19 (a) and (b), complete Schedule L-1 on page 4 of Instructions, and enter result in line 10 of Attach completed schedule.

FOOTNOTE 2.—If your current net income for 1942 or 1943 exceeded \$20,000, requiring you to complete Schedule L-2, enter here the amount shown on line 22 of 27 of such schedule, \$ _____ and increase 19 (c) by such amount.

Schedule K—VICTORY TAX. (See Tax Computation Instructions)

1. Victory Tax net income (item 19, page 1)		\$ 7,515.32
2. Less: Specific exemption (\$624 if return reports income of only one person; otherwise, see Instructions, page 5)		624.00
3. Income subject to Victory Tax (line 1 less line 2)		\$ 6,891.32
4. Victory Tax before credit (5% of line 3)		\$ 344.57
5. Victory Tax credit:		
(a) Single person, or married person not living with husband or wife: 25% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent)		\$ _____
(b) Married person living with husband or wife if separate returns are filed: 40% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent)		\$ _____
(c) Married person living with husband or wife if only one return or a joint return is filed, or head of a family: 40% (plus 2% for each dependent) of line 4; but not more than \$1,000 (plus \$100 for each dependent). (See Schedule L-1-2), for exclusion of one dependent by head of a family)		\$ 144.72
6. Net Victory Tax (line 4 less line 5). (Enter in line 13, above)		\$ 199.85

Schedule L.—To be used only by individuals whose surtax net income for 1942 or 1943 exceeded \$20,000. Schedule to determine whether Section 6 (c) of the Current Tax Payment Act of 1943 is applicable.

1. Surtax net income for 1942 (Item 23, Form 1040 (1942))	\$ _____
2. Surtax net income for 1943 (line 4, above)	\$ _____
3. Surtax net income for base year, \$ _____ plus \$20,000: \$ _____ (Check year used: 1937 ____; 1938 ____; 1939 ____; 1940 ____)	

If either line 1 or 2 is greater than line 3, separate Schedule L-2 should be secured from the collector and filed with and as a part of this return.

Note.—If a joint return is filed for either 1942 or 1943 and separate returns for the other of such years, enter the aggregate of the separate surtax net incomes for the separate return year. The surtax net income to be entered in line 3 shall be determined in the same manner as the surtax net income entered in line 1 or 2, whichever is the lesser.

STATEMENT OF TAX LIABILITY AND PAYMENTS ON ACCOUNT OF INDIVIDUAL INCOME TAX RETURN FOR 1942

To Federal Income Taxpayer named below: For the purpose of assisting you in the preparation of your 1943 income tax return, there is shown hereon certain information taken from the records of this office pertaining to your Federal income tax account for the taxable year 1942. This information must be entered on your 1943 return, and this Statement should be attached to the return in support of the entries. Do not make any changes in this Statement. If the figures do not agree with your records, return the Statement at once with a letter of explanation.

COLLECTOR OF INTERNAL REVENUE, PORTLAND, OREGON

ALFRED V PETERSEN
625 S E 52ND
PORTLAND ORE

29723

Total tax shown on your 1942 income
tax return—

\$ 1157 16

Paid at time of filing and as result of
bills subsequently issued—

\$ 578 58

THIS STATEMENT SHOULD BE ATTACHED TO YOUR 1943 INCOME TAX RETURN WHEN FILED WITH COLLECTOR OF INTERNAL REVENUE

UNITED STATES
INDIVIDUAL INCOME TAX RETURN

Page 1
1942

OPTIONAL FORM 1040A MAY BE FILED INSTEAD OF THIS FORM IF GROSS INCOME IS REPORTED ON THE CASH BASIS FOR THE CALENDAR YEAR. IS NOT MORE THAN \$3,000, AND CONSISTS WHOLLY OF SALARY, WAGES, OTHER COMPENSATION FOR PERSONAL SERVICES, DIVIDENDS, INTEREST OR ANNUITIES.

FOR CALENDAR YEAR 1942

or fiscal year beginning Jan. 1., 1942, and ending Jan. 1, 1943

PRINT NAME AND ADDRESS PLAINLY. (See Instruction C)

Henry M. and Elizabeth B. Mason

(Name) (Use given names of both husband and wife, if this is a joint return)
2856 S. W. Georgian Place

(Street and number, or rural route)
Portland Multnomah Oregon

(Post office) (County) (State)

Construction Sup'ts. 543-10-7215

(Occupation) (Social Security number, if any)

Ross B. Hammond Co., Spalding Building.

(Name and address of employer)

Portland, Oregon

(If more than one employer, attach statement showing name and address and amount received from each)

(Do not use these spaces)

File Code 44

Serial No. 19869

District 10

(Cashier's Stamp)

Cash—Check—M. O.

First Payment

Item and Instruction No.	INCOME	Amount	Deductible Expenses (Attach itemized statement)
1. Salaries and other compensation for personal services.	\$10,000.00	\$ 10,000 00	
2. Dividends:			
3. Interest on bank deposits, notes, etc.		202 05	
4. Interest on corporation bonds, etc.	\$	\$	Less amortizable bond premium
5. Interest on Government obligations, etc.:			
(a) From line (1), Schedule A	\$	\$	
(b) From line (1), Schedule A	\$	\$	
6. Rents and royalties. (From Schedule B)		17 24	
7. Annuities			
ITEMS 8, 9, AND 10, BELOW (AND PAGES 3 AND 4) NEED NOT BE CONSIDERED UNLESS YOU HAVE INCOME (OR LOSSES) IN ADDITION TO ITEMS ABOVE.			
8. (a) Net gain (or loss) from sale or exchange of capital assets. (From Schedule F)			
(b) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule G)			
9. Net profit (or loss) from business or profession. (From Schedule H)			
(State total receipts, from line 1, Schedule H, \$)			
10. Income (or loss) from partnerships; fiduciary income; and other income. (From Schedule I)			
11. Total income in items 1 to 10		\$ 10,202 05	
DEDUCTIONS			
12. Contributions paid. (Explain in Schedule C)		\$ 22 00	
13. Interest. (Explain in Schedule C)			
14. Taxes. (Explain in Schedule C)		814 47	
15. Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule C)			
16. Bad debts. (Explain in Schedule C)			
17. Other deductions authorized by law. (Explain in Schedule C)			
18. Total deductions in items 12 to 17		836 47	
19. Net income (item 11 minus item 18)		\$ 9,365 58	

COMPUTATION OF TAX

20. Net income (item 19 above)	\$ 9,365 58	27. Normal tax (6% of item 26)	\$ 391 74
21. Less: Personal exemption. (From Schedule D-1)	\$ 1,200 00	28. Surtax on item 23. (See Instruction 28)	1,331 74
22. Credit for dependents. (From Schedule D-2)	700 00	29. Total (item 27 plus item 28)	\$ 1,723 48
23. Balance (surtax net income)	\$ 7,465 58	30. Total tax (Item 29 or line 16, Schedule F)	\$
24. Less: Item 5 (a) above	\$	31. Less: Income tax paid at source	\$
25. Earned income credit. (From Schedule E-1 or E-2)	936 58	32. Income tax paid to a foreign country or U. S. possession. (Attach Form 1116)	\$
26. Balance subject to normal tax	\$ 6,529 02	33. Balance of tax (Item 30 minus items 31 and 32)	\$ 1,723 48

I/we declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) has been examined by me/us and to the best of my/our knowledge and belief is a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued under authority thereof.

(Signature of person (other than taxpayer or agent) preparing return)

(Date)

(Name of firm or employer, if any)

CP
(If this is a
A return ma

Henry M. Mason 3/1/43

Schedule A.—INTEREST ON GOVERNMENT OBLIGATIONS, ETC. (See Instruction 5)

1. Obligations or securities	2. Amount owned at end of year including your proportionate share of such obligations held by estates, trusts, partnerships, or common trust funds	3. Interest received or accrued during the year	4. Amount of principal interest on which a receipt from taxpayer	5. Interest on amount of principal interest and dividends (see instructions)
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	\$	\$	All	XXXXXX
(b) Obligations issued prior to March 1, 1941, under Federal Farm Loan Act, or under such Act as amended			All	XXXXXX
(c) Obligations of United States issued on or before September 1, 1917			All	XXXXXX
(d) Treasury Notes issued prior to December 1, 1940, Treasury Bills and Treasury Certificates of Indebtedness issued prior to March 1, 1941			All	XXXXXX
(e) United States Savings Bonds and Treasury Bonds issued prior to March 1, 1941			All	XXXXXX
(f) Obligations of instrumentalities of the United States (other than obligations to be reported in (b) above) issued prior to March 1, 1941			\$5,000	\$
(g) Dividends on share accounts in Federal savings and loan associations in case of shares issued prior to March 28, 1942	XXXXXX	XXXXXX	None	XXXX
(h) Total (enter as item 5 (a), page 1)				\$

(f) Treasury Notes issued on or after December 1, 1940, and obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof (enter amount of interest as item 5 (b), page 1) \$ Amount owned at end of year Interest received or accrued during the year (subject to normal tax and surtax) \$

Schedule B.—INCOME FROM RENTS AND ROYALTIES. (See Instruction 6)

1. Kind of property	2. Amount	3. Depreciation or depletion (attach schedule)	4. Repairs (explain below)	5. Other expenses (itemize below)	6. Net profit (column 2 minus sum of columns 3, 4, and 5) (enter as item 6, page 1)
House—Warrendale	135 00	150 00			
" Cannon Beach	190 00	150 00	16 66	27 23	

Explanation of deductions claimed in columns 4 and 5: Roof repairs 16.66, water 7.00, light 7.43, wood 13.50 all in connection with tenant occupancy only.

Schedule C.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 12, 13, 14, 15, 16, AND 17

1. Item No.	2. Explanation	3. Amount	1. Item No. (Continued)	2. Explanation (Continued)	3. Amount (Continued)
12	Community Chest	15 00	14	State Income Tax	260 57
	Red Cross	5 00		Property Tax - Home	437 29
	T. B. Seals	2 00		" Warrendale	50 28
				" Cannon Beach	66 33

Schedule D.—EXPLANATION OF CREDITS CLAIMED IN ITEMS 21 AND 22. (See Instructions 21 and 22)

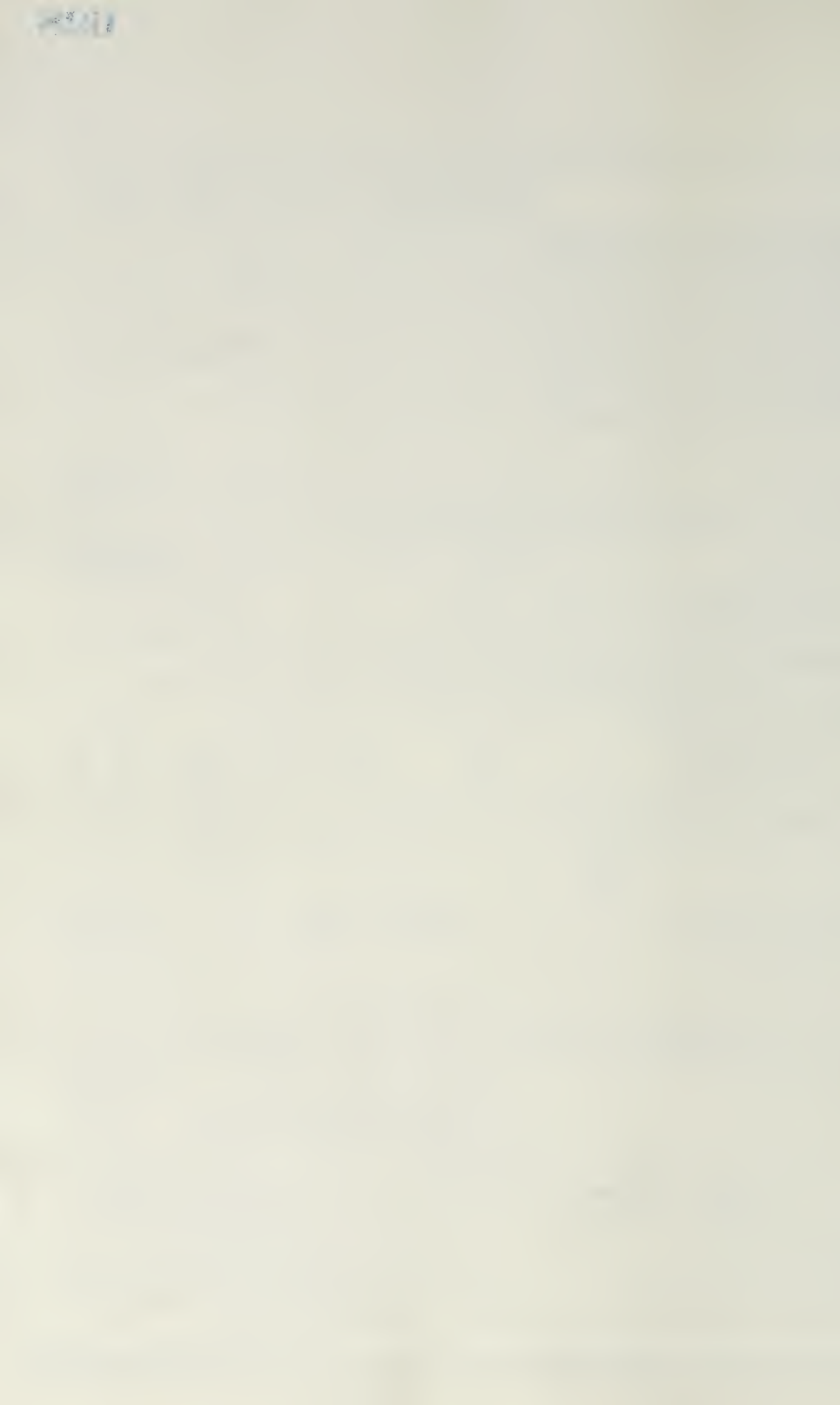
(1) Personal Exemption			(2) Credit for Dependents		
Status	Number of months during the year in each status	Credit claimed	Name of dependent and relationship	Number of months during the year Under 18 years old 18 years or over	Credit claimed
Single, or married and not living with husband or wife, and not head of family		\$	Henry R. Mason	12	350 00
Married and living with husband or wife	12	1,200 00	Thomas G. Mason	12	350 00
Head of family (explain below)					
			Reason for support if 18 years or over		

Schedule E.—COMPUTATION OF EARNED INCOME CREDIT. (See Instruction 25)

(1) If your net income is \$3,000 or less, use only this part of schedule		(2) If your net income is more than \$3,000, use only this part of schedule	
Net income (item 19, page 1)	\$	Earned net income (not more than \$14,000)	\$ 10,000 00
Earned income credit (10% of net income, above)		Net income (item 19, page 1)	9,365 58
		Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but do not enter less than \$300)	936 58

QUESTIONS

- Did you file a return for any prior year? **Yes** If so, what was the latest year? **1941** To which Collector's office was it sent? **Portland, Oregon**
- If separate return was made for the current year, state:
 - Name of husband or wife
 - Personal exemption, if any, claimed thereon
 - Collector's office to which it was sent
- Check whether this return was prepared on the cash ☒ or accrual ☐ basis.
- Was the rate of your salary or wages increased or decreased after October 3, 1942, and before the end of your taxable year? **No** (Yes or No)
- Did you receive during your taxable year any amount claimed to be non-taxable other than interest reported in Schedule A (see Instruction H)? **No** If so, attach schedule showing source, nature, and amount of such income.
- Did you at any time during your taxable year own directly or indirectly any stock of a foreign corporation or a personal holding company as defined by section 501 of the Internal Revenue Code? **No** If so, attach statement required by Instruction K.



UNITED STATES
INDIVIDUAL INCOME AND VICTORY TAX RETURN

15720 Page 1
1943

OPTIONAL FORM 1040A MAY BE FILED INSTEAD OF THIS FORM IF GROSS INCOME IS REPORTED ON THE CASH BASIS FOR THE CALENDAR YEAR, IS NOT MORE THAN \$3,000, AND CONSISTS WHOLLY OF SALARY, WAGES, OTHER COMPENSATION FOR PERSONAL SERVICES, DIVIDENDS, INTEREST OR ANNUITIES

FOR CALENDAR YEAR 1943

or fiscal year beginning Jan. 1, 1943, and ending Jan. 1, 1944

PRINT NAME AND ADDRESS PLAINLY. (See Instruction C)

Henry M. & Elizabeth R. Mason
(Name) (Use given names of both husband and wife, if this is a joint return)
1833 S.W. Laurel St.
(Street and number, or rural route)
Portland Oregon
(City or town) (State)

Occupation Construction Supt. Social Security number, if any 513-12-7215

(Do not use these spaces)

File Code 235
Serial No. 303837
Oregon
District
(Cashing's Stamp)
RECEIVED
MAR 11 1944
DIST. OREGON

COMPUTATION OF NET INCOME

INCOME		Column 1 Income Tax Net Income	Column 2 Victory Tax Net Income
1. Salary, Wages, and Compensation for Personal Services	Employer's Name: Ross B. Hammond Co. City and State: Portland Ore.	\$10.000 00	\$10.000 00
(Members of armed forces see Instruction I)			
Total		\$10.000 00	\$10.000 00
Less: Deductible expenses (See Instructions 12 and 16 for Victory Tax deduction)			
Compensation after deductible expenses		\$10.000 00	\$10.000 00
2. Dividends			
3. Interest on corporation bonds and deposits, etc.		11 21	11 21
4. Interest on Government obligations, etc. (From line A (8), Schedule A)			XXXXXX XX
(From line B (5) and (3), Schedule A)			
5. Annuities			
6. (a) Net gain (or loss) from sale or exchange of capital assets. (From Schedule B)			XXXXXX XX
(b) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule B)			
7. Rents and royalties. (From Schedule C (1))		29 32	29 32
8. Net profit (or loss) from business or profession. (From Schedule C (2))			
(State total receipts, from line 1, Schedule C (2) \$)			
9. Income (or loss) from partnerships; fiduciary income; and other income. (From Schedule C (3))			
10. Total income in items 1 to 9		\$10.100 53	\$10.100 53
DEDUCTIONS			
11. Contributions. (Explain in Schedule D)		\$ 00 00	XXXXXX XX
12. Interest. (Explain in Schedule E) (See Instructions 12 and 16 for Victory Tax deduction)			XXXXXX XX
13. Taxes. (Explain in Schedule F) (See Instructions 13 and 14 for Victory Tax deduction)		690 51	XXXXXX XX
14. Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule G)			XXXXXX XX
15. Medical, dental, etc., expenses. (Explain in Schedule H)			XXXXXX XX
16. Other deductions authorized by law. (Explain in Schedule G)			\$ 63 66
17. Total deductions in items 11 to 16		\$ 770 51	\$ 63 66
18. Income Tax net income (item 10, col. 1, less item 17, col. 1)		\$ 9,330 02	XXXXXX XX
19. Victory Tax net income (item 10, col. 2, less item 17, col. 2)		XXXXXX XX	\$10,036 07
INCOME AND VICTORY TAX			
20. Unpaid balance of 1943 Income and Victory Tax (from line 22, page 4)			\$ 169 20
21. You may postpone, until not later than March 15, 1945, payment of the amount you owe up to one-half of item 19 (c), page 4. Enter the amount postponed. (For persons whose surtax net income for 1942 or 1943 exceeded \$20,000, see Schedule L-2)			
22. Amount paid with this return (item 20 less item 21)			\$ 169 20
23. Refund or Credit	If the total of your payments (line 21 (d) on page 4) is larger than your tax (line 20 on page 4), enter the difference. Indicate by a check mark (✓) what you want done with this overpayment: Refund it to me <input type="checkbox"/> ; Apply it on my 1944 estimated tax <input type="checkbox"/> .		

I declare under the penalties of perjury, that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person (other than taxpayer or agent) preparing return) (Date) Henry M. Mason 3/10/44

(Signature of taxpayer) Elizabeth R. Mason

(If this is a joint return (not made by agent), it must be signed by both husband and wife. A return may be signed by either if the other is deceased.)

THOSE WHOSE INCOME IS SOLELY FROM SALARIES MAY DISREGARD THIS PAGE Page 2

Schedule A.—INTEREST AND OWNERSHIP OF TAXABLE GOVERNMENT OBLIGATIONS, ETC. (See Instruction 4)

1. Obligations or securities	2. Amount owned at end of year (per value except for United States savings bonds)	3. Interest
A. Subject to surtax only:		
(1) United States savings bonds (cost price) and Treasury bonds issued prior to March 1, 1941.....	\$.....	\$.....
(2) Less: Wholly tax-exempt portion, principal amount not in excess of \$5,000.....	XXXXXXXXXX xx	.....
(3) Net taxable interest.....	XXXXXXXXXX xx	\$.....
(4) Obligations of instrumentalities of the United States issued prior to March 1, 1941 (other than Federal land banks, Federal intermediate credit banks, or joint stock land banks).....	\$.....	.....
(5) Dividends on share accounts in Federal savings and loan associations in case of shares issued prior to March 28, 1942.....	XXXXXXXXXX xx	.....
(6) Subtotal for interest (total of lines 3, 4, and 5).....	XXXXXXXXXX xx	\$.....
(7) Less: Amortizable bond premium. (See Instruction 16).....	XXXXXXXXXX xx	.....
(8) Balance of interest. (Enter as item 4 (a), column 1, page 1).....	XXXXXXXXXX xx	\$.....
B. Subject to normal tax, surtax, and Victory Tax:		
(1) United States savings bonds issued on or after March 1, 1941 (cost price).....	\$.....	\$.....
(2) Other obligations issued on or after March 1, 1941, by the United States or any instrumentality thereof (include also Treasury notes issued on or after December 1, 1940).....	.....	.....
(3) Subtotal for interest (total of lines 1 and 2). (Enter as item 4 (b), column 2, page 1).....	XXXXXXXXXX xx	\$.....
(4) Less: Amortizable bond premium. (See Instruction 16).....	XXXXXXXXXX xx	.....
(5) Balance of interest. (Enter as item 4 (b), column 1, page 1).....	XXXXXXXXXX xx	\$.....

Schedule B.—Schedule B (Form 1040) is a separate sheet and should be used in reporting gains and losses from sales or exchanges of capital assets and property other than capital assets, and filed with and as a part of this return.

Schedule C(1).—INCOME FROM RENTS AND ROYALTIES. (See Instruction 7)

1. Kind of property	2. Amount	3. Depreciation or depletion (explain below)	4. Repairs (explain below)	5. Other expenses (itemize below)	6. Net profit (column 2 less sum of columns 3, 4, and 5) (enter as item 7, page 1)
House - Cavanaugh Beach	\$ 335.00	\$ 150.00	\$ 35.50	\$ 60.18	\$ 89.32

Schedule C(2).—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION. (See Instruction 8)

(State (1) nature of business; (2) business name)

1. Total receipts		3. Cost of goods sold	OTHER BUSINESS DEDUCTIONS	
(To be used where inventories are an income-determining factor) (Enter the letters "C," or "C or M," on lines 2 and 8 if inventories are valued at either cost, or cost or market, whichever is lower)			11. Salaries and wages not included as "Labor" (do not deduct compensation for yourself).....	
2. Inventory at beginning of year.....	\$.....	0.00	12. Interest on business indebtedness.....	
3. Merchandise bought for sale.....	.....	.....	13. Taxes on business and business property.....	
4. Labor.....	.....	.....	14. Losses (explain below).....	
5. Material and supplies.....	.....	.....	15. Bad debts arising from sales or services.....	
6. Other costs (explain below).....	.....	.....	16. Depreciation, obsolescence, and depletion (explain below).....	
7. Total of lines 2 to 6.....	\$.....	.....	17. Rent, repairs, and other expenses (explain below).....	
8. Less inventory at end of year.....	.....	.....	18. Amortization of emergency facilities (attach statement).....	
9. Net cost of goods sold (line 7 less line 8).....	\$.....	.....	19. Total of lines 11 to 18.....	
10. Gross profit (line 1 less line 9).....	\$.....	.....	20. Total of lines 9 and 19.....	
			21. Net profit (or loss) (line 1 less line 20). (Enter as item 8, page 1).....	

EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN COLUMN 3 AND LINE 16, ABOVE

1. Kind of property (If buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (Do not include land or other nondepreciable property)	4. Assets fully depreciated in use at end of year	5. Depreciation allowed (or allowable) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in accumulating depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
House - wood frame	1936	\$ 3,000.00	\$ 1,950.00	\$ 1,050.00	\$ 1,950.00	20 yrs.	13 yrs.	\$ 150.00

EXPLANATION OF DEDUCTIONS CLAIMED IN COLUMNS 4 AND 5, AND LINES 6, 14, AND 17, ABOVE

1. Column or Line No.	2. Explanation	3. Amount	1. Column or Line No.	2. Explanation	3. Amount
4	New stove coils and clean electric tank	\$ 35.50	5	Light, water, wood, grass cutting	\$ 60.18

Schedule C(3).—INCOME FROM PARTNERSHIPS, FIDUCIARIES, AND OTHER SOURCES (See Instructions 9, 10, 11, and 12)

Partnership, syndicate, etc.....
Fiduciary.....
Other.....
(See Instructions 9, 10, 11, and 12)
Page 1

Schedule D.—CONTRIBUTIONS. (See Instruction 11)

Contributions (cont'd) Page 3
Schedule E.—INTEREST. (See Instruction 12)

1. Name and Address of Organization	2. Amount	1. To Whom Paid	2. Amount
Am. Soc. Civil Engineers	\$ 20.00	Community Chest	\$ 15.00
Red Cross	10.00	Ore. T. B. Soc.	2.00
Old Peoples Home	1.00	Yale University	10.00
St. Helens Hall	5.00	Police Pension Fund	2.00
Junior League	15.00		
Total. (Enter as item 11, page 1, subject to 15% limitation).	\$ 66.00	Total. (Enter as item 12, page 1).	\$ 30.00

Schedule F.—TAXES. (See Instruction 13)

Schedule G.—LOSSES AND OTHER DEDUCTIONS. (See Instructions 14 and 16)

1. Nature	2. Amount	1. Item No.	2. Explanation	3. Amount
State Income	\$ 380.43	16	Taxes on property	\$ 63.66
Property Tax Home	216.42		held for production	
" " Warrendale	27.80		of income	
" " Cannon Beach	35.80			
Total. (Enter as item 13, page 1).	\$ 690.51			

Schedule H.—MEDICAL, DENTAL, ETC., EXPENSES. (See Instruction 15)

1. Name and Address of Person to Whom Payments Were Made	2. Approximate Date of Actual Payment	3. Amount
		\$
1. Total medical, dental, etc., expenses actually paid during the year as shown in column 3, above		\$
2. Amount received during the year as compensation for such expenses		
3. Payment for medical care not compensated for during the year (line 1 less line 2)		\$
4. Total income in item 10, page 1	\$	
5. Total deductions claimed in items 11, 12, 13, 14, and 16, page 1	\$	
6. Net income before deduction for medical, dental, etc., expenses (line 4 less line 5)	\$	
7. 5% of line 6		
8. Excess of line 3 over line 7. (Enter as item 15, page 1, subject to maximum limitation.) (See Instruction 15)		\$

Schedule I.—PERSONAL EXEMPTION AND CREDIT FOR DEPENDENTS. (See Tax Computation Instructions)

(1) Personal Exemption			(2) Credit for Dependents		
Status	Number of months during the year in each status	Credit claimed	Name of dependent and relationship	Number of months during the year	Credit claimed (Head of a family may not claim credit for dependent used to qualify him as head of a family)
				Under 18 years old	18 years or over
Single, or married and not living with husband or wife, and not head of family		\$	Sons		
Married and living with husband or wife	12	1,200.00	Henry R.	12	350.00
Head of a family (explain below)			Thomas G.	12	350.00
			James M.	2	58.33
			Reason for support if 18 years or over		758.33

Schedule J.—COMPUTATION OF EARNED INCOME CREDIT. (See Tax Computation Instructions)

(1) If your net income is \$3,000 or LESS, use only this part of schedule		(2) If your net income is MORE than \$3,000, use only this part of schedule	
Net income (item 18, page 1)	\$	Earned net income (not more than \$14,000)	\$ 12,000.00
Earned income credit (10% of net income, above)		Net income (item 18, page 1)	2,230.00
		Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but do not enter less than \$300)	933.00

QUESTIONS

- Did you file a return for any prior year? Yes. If so, what was the latest year? Portland, Ore. To which Collector's office was it sent? Portland, Ore.
- If you claimed credit for tax paid in line 21 (c), page 4, to which Collector's office was your declaration sent? Portland, Ore.
- If separate return was made for the current year, state:
 - Name of husband or wife
 - Personal exemption, if any, claimed thereon
 - Collector's office to which it was sent
- Check whether this return was prepared on the cash ☒ or annual ☐ basis.
- Was the rate of your salary or wages increased or decreased during your taxable year? (Yes or No) No
- Did you receive during your taxable year any amount claimed to be non-taxable (see General Instruction 1)? No. If so, attach schedule showing source, nature, and amount of such income.
- Did you at any time during your taxable year own directly or indirectly any stock of a foreign corporation, or a personal holding company as defined by section 501 of the Internal Revenue Code? No. If so, attach statement required by General Instruction 1.

COMPUTATION OF INCOME AND VICTORY TAX. (See Tax Computation Instructions)

Page 4

1. Income Tax net income (item 18, page 1)		\$ 2,330.00	02
2. Less: Personal exemption. (From Schedule L-1)	\$ 1,200.00		
3. Credit for dependents. (From Schedule L-2)	7.58	33	
4. Balance (surtax net income)		1,058.33	33
5. Less: Certain interest on Government obligations (item 4 (a), page 1)	\$		
6. Earned income credit. (From Schedule J-1) or J-2)	9.33	00	
7. Balance subject to normal tax		933.00	00
8. Normal tax (6% of line 7)		55.98	62
9. Surtax on amount in line 4. (See Surtax Table, page 3 of Instructions)		3.09	21
10. Total Income Tax (line 8 plus line 9). (If Schedule B is used and alternative tax computation made, enter line 16, Schedule B)		59.07	83
11. Less: Income Tax paid to a foreign country or U. S. possession. (Attach Form 1116)			
12. BALANCE OF INCOME TAX		59.07	83
13. NET VICTORY TAX (line 6 of Victory Tax Schedule, below)	2.57		74
14. Total of lines 12 and 13		61.64	57
15. Income Tax paid at source on tax-free covenant bond interest. (See Footnote 1)			
16. Line 14 less line 15		61.64	57
17. Income Tax for 1942. (See Statement, Form 1125, from Collector) (First, see page 4 of Instructions)		61.64	57
18. Enter line 16 or 17 whichever is LARGER. (Members of the armed forces see page 4 of Instructions)		61.64	57
19. FORGIVENESS FEATURE (Don't fill in (a), (b), and (c) below, if either line 16 or 17 is \$50 or less):			
(a) Enter line 16 or 17, whichever is SMALLER	\$ 1,223.48		
(b) Enter \$50 or three-fourths of (a), immediately above, whichever is LARGER. This is the FORGIVEN part of the tax	\$ 1,292.61		
(c) Enter the UNFORGIVEN part of the tax which is the BALANCE (subtract (b) from (a)). (See Footnote 2)		130.87	
20. TOTAL INCOME AND VICTORY TAX. (Total of lines 18 and 19 (c))		178.51	
21. Less: (a) Income and Victory Tax withheld by employer	\$ 1,347.20		
(b) Income Tax paid on 1942 income	86.17		
(c) Tax paid on 1943 income on account of Declaration of Estimated Tax			
(d) Total payments		2,208.94	
22. UNPAID BALANCE OF INCOME AND VICTORY TAX. (If line 20 is larger than line 21 (d), enter the difference here and also as item 20, page 1; if not, see item 23, page 1)		162.20	

FOOTNOTE 1.—If you claim a credit in line 15, disregard lines 19 (a) and (b), complete Schedule L-1 on page 4 of Instructions, and enter result in line 19 (c). Attach completed schedule.

FOOTNOTE 2.—If your surtax net income for 1942 or 1943 exceeded \$20,000, requiring you to complete Schedule L-2, enter here the amount shown on line 10 or 27 of such schedule, \$, and increase 19 (c) by such amount.

Schedule K.—VICTORY TAX. (See Tax Computation Instructions)

1. Victory Tax net income (item 19, page 1)		\$ 1,023.67	87
2. Less: Specific exemption (\$624 if return reports income of only one person; otherwise, see Instructions, page 3)		713.33	
3. Income subject to Victory Tax (line 1 less line 2)		310.34	55
4. Victory Tax before credit (5% of line 3)		15.52	10
5. Victory Tax credit:			
(a) Single person, or married person not living with husband or wife: 25% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent)			
(b) Married person living with husband or wife if separate returns are filed: 40% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent)			
(c) Married person living with husband or wife if only one return or a joint return is filed, or head of a family: 40% (plus 2% for each dependent) of line 4, but not more than \$1,000 (plus \$100 for each dependent) (See Schedule L-2, for exclusion of one dependent by head of a family)		21.44	44
6. Net Victory Tax (line 4 less line 5). (Enter in line 13, above)		4.08	53

Schedule L.—To be used only by individuals whose surtax net income for 1942 or 1943 exceeded \$20,000. Schedule to determine whether Section 6 (c) of the Current Tax Payment Act of 1943 is applicable

1. Surtax net income for 1942 (item 23, Form 1040 (1942))	\$	
2. Surtax net income for 1943 (line 4, above)	\$	
3. Surtax net income for base year, \$, plus \$20,000: \$, (Check year used: 1937 ; 1938 ; 1939 ; 1940 ;)	\$	

If either line 1 or 2 is greater than line 3, separate Schedule L-2 should be secured from the collector and filed with and as a part of this return.

Note.—If a joint return is filed for either 1942 or 1943 and separate returns for the other of such years, enter the aggregate of the separate surtax net incomes for the separate return year. The surtax net income to be entered in line 3 shall be determined in the same manner as the surtax net income entered in line 1 or 2, whichever is the lesser.

Form 1042
TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE

STATEMENT OF TAX LIABILITY AND PAYMENTS ON ACCOUNT
OF INDIVIDUAL INCOME TAX RETURN FOR 1942

To Federal Income Taxpayer named below: For the purpose of assisting you in the preparation of your 1943 income tax return, there is shown hereon certain information taken from the records of this office pertaining to your Federal income tax account for the taxable year 1942. This information must be entered on your 1943 return, and this Statement should be attached to the return in support of the entries. Do not make any changes in this Statement. If the figures do not agree with your records, return the Statement at once with a letter of explanation.

COLLECTOR OF INTERNAL REVENUE, PORTLAND, OREGON

Total tax shown on your 1942 income
tax return—

\$ 1723 48

Paid at time of filing and as result of
bills subsequently issued—

\$ 861 74

HENRY M MASON &
ELIZABETH R MASON
2656 S W GEORGIAN PL
PORTLAND ORE

19869

THIS STATEMENT SHOULD BE ATTACHED TO YOUR 1943 INCOME TAX RETURN WHEN FILED WITH COLLECTOR OF INTERNAL REVENUE

DEFENDANT'S EXHIBIT No. 28

Ross B. Hammond Co.
Building Construction
1214 Spalding Building
Portland, Oregon

[Stamped]: Received Mar. 7, 1938. Rules and Regulations Division.

March 3rd, 1938.

Commissioner of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

Sir:

In accordance with requirements of Article 42-4, Regulations 94, application is hereby made for permission to account for profits upon contracts performed by this company, upon the basis of a percentage of contracts completed within each calendar year.

Doubtless this request is not necessary as no change is being made in the accounting methods heretofore employed, but on December 31st, 1937, the corporation, Ross B. Hammond, Inc., was dissolved and the business transferred to Ross B. Hammond, the sole stockholder of the corporation. The first return, of course, covering the operation of the business as a sole proprietorship, will be for the year 1938, and, as we understand the regulations, the method used upon the first return is optional with the taxpayer. However, since there been a change in the form of organization, it is desired to take every precaution possible to see that

Defendant's Exhibit No. 28—(Continued)

the method heretofore employed by the corporation is perpetuated and that the new ownership is permitted to file upon the same basis as that used by the corporation.

In view of the fact that the corporation's books had been kept on the accrual basis, the individual books would be kept on a similar basis and the returns made accordingly on the accrual basis.

A letter from you upon these points will be appreciated.

Very truly yours,

ROSS B. HAMMOND CO.

By /s/ ROSS B. HAMMOND.

RBH:EP

Mar. 29, 1938.

IT:HR:FMA

Mr. Ross B. Hammond,
c/o Ross B. Hammond Company,
1214 Spalding Building,
Portland, Oregon.

Sir:

Reference is made to your letter dated March 3, 1938, in which you request permission to report your gross income for the calendar year 1938 from contracts upon the basis of a percentage of completion of such contracts in accordance with the provisions of article 42-4, Regulations 94, which is the same method used by Ross B. Hammond, Inc., the assets and business of which were transferred to you as sole stockholder on December 31,

Defendant's Exhibit No. 28—(Continued)

1937, and now being operated as a sole proprietorship. It is assumed that no income was received by you as an individual from long-term contracts prior to January 1, 1938.

You are advised that to the extent that your income is derived from long-term contracts as defined in article 42-4 of Regulations 94, you may report your gross income from such contracts upon either of the two bases set forth in that article of the regulations. Which ever method is adopted by you in your first return must be followed for subsequent years, unless permission to change such method of accounting is obtained from the Commissioner as provided in article 41-2 of Regulations 94.

Respectfully,

JOHN R. KIRK,
Deputy Commissioner.

By
Head of Division.

FMA/ERH-1

Defendant's Exhibit No. 28—(Continued)

[Notation]: Change of accounting, 3/29/38.

[Stamped]: Received Apr. 8, 1938, Rules and Regulations Division.

Ross B. Hammond Co.
Building Construction
1214 Spalding Building
Portland, Oregon

April 5, 1938.

IT:RR:FMA

Mr. John R. Kirk,
Deputy Commissioner of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

Dear Sir:

On March 3rd, 1938, the writer addressed a letter to the Commissioner of Internal Revenue stating that Ross B. Hammond, Inc., a corporation, had been dissolved, and the business transferred to me, the sole stockholder. I requested permission to report income from contracts, as an individual, on a percentage of completion basis, as the corporation had previously been doing, and to keep all accounts and make all returns on an accrual basis. Your reply of March 29th, grants permission to me to report income from contracts as the corporation had been doing, but makes no statement regarding keeping all accounts on an accrual basis.

Up to the year 1938, Ross B. Hammond, Inc., a corporation, made all of their returns on an ac-

Defendant's Exhibit No. 28—(Continued)

crual basis, and Ross B. Hammond, as an individual, who kept no books, made all of his returns on a cash basis.

The corporation has been dissolved, and all future returns will be made as an individual, and, since the main income of Ross B. Hammond is from the construction business which has been kept on an accrual basis, we therefore, request definite permission to make all future returns of Ross B. Hammond as an individual on the same basis as the corporation had previously made returns, which is the accrual basis.

Very truly yours,

R. B. HAMMOND CO.,

/s/ R. B. HAMMOND.

RBH:EP

IT:E:6

LBV

Apr. 25, 1938.

Mr. Ross B. Hammond,
1214 Spalding Building,
Portland, Oregon.

Sir:

Reference is made to your letter dated April 5, 1938, in connection with your request dated March 3, 1938, for permission to change your method of reporting income from the cash to the accrual basis, beginning with the taxable year ending December 31, 1938.

Defendant's Exhibit No. 28—(Continued)

In order that proper consideration may be given to your application it is necessary that information be submitted showing as at the end of the taxable year 1937 the amounts of all items of (a) income accrued but not received; (b) income received in advance of when earned; (c) expenses accrued but not paid, and (d) expenses prepaid. The principal items comprising the foregoing classifications should be stated with the respective amounts thereof. It should also be stated how each of the foregoing classifications was treated for Federal income tax purposes for the taxable year 1937.

Upon receipt of the information requested, consideration will be given to the matter.

Respectfully,

JOHN R. KIRK,
Deputy Commissioner.

By P. W. LUCKETT,
Acting Head of Division.

[Pencil Notations on bottom of page illegible.]

Defendant's Exhibit No. 28—(Continued)

[Stamped]: Received May 11, 1938, Audit Division E.

Ross B. Hammond Co.
Building Construction
1214 Spalding Building
Portland, Oregon

IT:E:6
LBV

May 9, 1938.

Mr. John R. Kirk,
Deputy Commissioner of Internal Revenue,
Internal Revenue Building
Washington, D. C.

Dear Sir:

Replying to your letter dated April 25, 1938, regarding permission to change my method of reporting income from cash to the accrual basis, beginning with the taxable year 1938, please be advised that all items on my personal return for 1937 were reported upon the cash basis, hence:

(a) There was no accrual of income not received;

(b) No income received in advance of when earned;

(c) No expenses accrued but not paid; and

(d) No expenses prepaid.

Accordingly none of these items were shown on the tax return for the year 1937.

Defendant's Exhibit No. 28—(Continued)

As previously stated, the reason for seeking permission to file on the accrual basis is occasioned by the fact that I have personally taken over the contracting business previously conducted by Ross B. Hammond, Inc., and, as you have been advised heretofore, the accounts of that company were kept on the accrual basis. Request has therefore been made for permission to report my income from the contracting business upon the accrual basis, and it is desired that the return be uniform with respect to my personal income.

I trust this is the information you desire, but, if not, I shall be glad to hear from you further.

Yours very truly,

/s/ R. B. HAMMOND.

RBH EP

DEFENDANT'S EXHIBIT No. 29

Statement

[Red Pencil]:

IT:R:A:Recomp.

Recd 6/20/47

[Illegible.]

In re: Ross B. Hammond, Portland, Oregon.

[Illegible.]

Years: 1942 and 1943

Income Tax			
Years	Liability	Prior Liability	Deficiency
1942-1943	\$284,559.71	\$264,356.42	\$203.29

This computation is made on the basis that 75%

Defendant's Exhibit No. 29—(Continued)

of the income of the partnership of Ross B. Hammond Company, exclusive of any credits to R. M. Mason and A. V. Peterson, is taxable to the above-named taxpayer.

1942

Net income, agent's report dated August 29, 1944.....	\$316,252.49
Less: Partnership income overstated.....	10,391.62
Net income adjusted	<u>\$305,860.87</u>
Less: Personal exemption	\$1,200.00
Credit for dependent	350.00
	<u>1,550.00</u>
Balance (surtax net income).....	\$304,310.87
Less: Earned income credit (10% of \$14,000.00).....	1,400.00
Normal tax net income.....	<u>\$302,910.87</u>
Normal tax at 6% on \$302,910.87.....	\$ 18,174.65
Surtax on \$304,310.87	242,674.91
Total tax	<u>\$242,849.56</u>

1943

	Income Tax Net Income	Victory Tax Net Income
Net income, agent's report dated		
August 29, 1944	\$ 78,224.01	\$ 80,647.65
Add: Partnership income	42,475.56	42,475.56
Net income adjusted	<u>\$120,699.57</u>	<u>\$123,123.21</u>

Computation of Victory Tax

Victory tax net income	\$123,123.21
Less: Specific credit	624.00
Income subject to victory tax.....	<u>\$122,499.21</u>
Victory tax at 5% on \$122,499.21.....	6,124.96
Less: Victory tax credit	600.00
Net victory tax	<u>\$ 5,524.96</u>

Defendant's Exhibit No. 29—(Continued)

Computation of Income Tax—Alternative Tax
(Applicable)

Net income adjusted	\$120,699.57
Less: Net long-term capital gain.....	50.00
<hr/>	
Ordinary net income	\$120,649.57
Less: Personal exemption	\$1,200.00
Credit for dependent	350.00
	1,550.00
<hr/>	
Balance (surtax net income).....	\$119,099.57
Less: Earned income credit (10% of \$14,000.00).....	1,400.00
<hr/>	
Balance subject to normal tax.....	\$117,699.57
Normal tax at 6% on \$117,699.57.....	\$ 7,061.97
Surtax on \$119,099.57	74,228.66
<hr/>	
Partial tax	\$ 81,290.63
Plus 50% of net long-term gain of \$50.00.....	25.00
<hr/>	
Alternative tax	\$ 81,315.63
Total income tax	\$ 81,315.63
Plus: victory tax	5,524.96
<hr/>	
Total income tax and victory tax.....	\$ 86,840.59
Income tax for 1942.....	\$242,849.56
Amount of 1942 or 1943 tax whichever is larger.....	\$242,849.56
<hr/>	
Forgiveness feature (not to be used if either 1942 or 1943 tax is \$50.00 or less):	
(a) Amount of 1942 or 1943 tax whichever is smaller	
	\$86,840.59
(b) Amount forgiven (\$50.00 or three- fourths of (a), whichever is larger)....	
	65,130.44
<hr/>	
(c) Amount forgiven	\$ 21,710.15
<hr/>	
Total income and victory tax liability.....	\$264,559.71
Income tax previously determined.....	264,356.42
<hr/>	
Increase in income and victory tax.....	\$ 203.29

Defendant's Exhibit No. 29—(Continued)

Explanation of Adjustments—1942-1943

It is held that during the years 1942 and 1943 a partnership existed between Ross B. Hammond and his son, William A. Hammond, and that profits therefrom should be taxed 75 percent to the father and 25 percent to the son; also that the amounts of \$86,635.86 credited to the accounts of H. M. Mason and A. V. Peterson in 1942 and \$77,366.37 in 1943 could not be considered constructively received and therefore the two partners should be taxed upon the entire income exclusive of the credits above indicated, or a redistribution of partnership income as follows:

1942

Net income of partnership Ross B. Hammond and Company before credits of \$86,635.88 to H. M. Mason and A. V. Peterson:	
(Report dated December 21, 1945).....	\$410,610.02
Add: Salary paid to William A. Hammond.....	7,500.00
	<hr/>
Total adjusted partnership income.....	\$418,110.02
Ross B. Hammond share: 75% of \$418,110.02.....	\$313,582.52
Amount previously reported	
(report dated August 29, 1946).....	323,974.14
	<hr/>
Decrease in income	\$ 10,391.62

1943

Net income of partnership Ross B. Hammond and Company before credits of \$77,366.37 to H. M. Mason and A. V. Petersen:	
(Report dated April 12, 1947).....	\$162,063.26
Add: Salary paid to William A. Hammond.....	7,500.00
	<hr/>
Total partnership income	\$169,563.26
Ross B. Hammond share: 75% of \$169,563.26.....	\$127,172.45
Previously reported	
(report dated August 29, 1946).....	84,696.89
	<hr/>
Increase in income	\$ 42,475.56

Defendant's Exhibit No. 29—(Continued)

Statement

IT:R:A—Recomp. [Red Pencil] Recd 6/20/47
[Illegible.]

In re: William A. Hammond, Portland, Oregon

Years 1942 and 1943

Years	Income Tax Liability	Prior Liability	Deficiency
1942-1943	\$61,910.57	\$28,100.23	\$33,810.34

This computation is made on the basis that 25 per-
cent of the income of the partnership of Ross B.
Hammond and Company, exclusive of any credits
to H. M. Mason and A. V. Peterson, is taxable to the
above-named taxpayer.

1942

Net income shown on amended return.....	\$ 44,933.10
Add: Partnership income understated.....	59,897.85
Net income adjusted	\$104,830.95
Less: Personal exemption	1,200.00
Balance (Surtax net income).....	\$103,630.95
Less: Earned income credit: (10% of \$14,000.00).....	1,400.00
Normal tax net income.....	\$102,230.95
Normal tax at 6 percent on \$102,230.95.....	\$ 6,133.86
Surtax on \$103,630.95	62,008.45
Total tax	\$ 68,142.31

Defendant's Exhibit No. 29—(Continued)

1942 Recomputed

Section 6(d)(1) Current Tax Payment Act of 1943

Net income shown on amended return.....	\$ 44,933.10
Add: Partnership income understated.....	59,897.85
Net income adjusted	\$104,830.95
Amount of earned income excluded under section 6(d)	
(1) Current Tax Payment Act of 1943.....	14,000.00
Balance	\$ 90,830.95
Less: Personal exemption	1,200.00
Balance (surtax net income).....	\$ 89,630.95
Less: Earned income credit.....	None
Normal tax net income.....	\$ 89,630.95
Normal tax at 6% on \$89,630.95.....	\$ 5,377.86
Surtax on \$89,630.95	51,163.21
Total tax	\$ 56,541.07

1943

	Income tax net income	Victory tax net income
Net income reported on return.....	\$44,115.59	\$44,493.60
Less: Partnership income overstated.....	1,654.29	1,654.29
Net income adjusted	\$42,461.30	\$42,839.31

Computation of Victory Tax

Victory tax net income.....	\$ 42,839.31
Less: Specific exemption	624.00
Income subject to victory tax.....	\$ 42,215.31
Victory tax at 5% on \$42,215.31.....	\$ 2,110.77
Less credit: 40% of \$2,110.77.....	844.31
Net victory tax	\$ 1,266.46

Defendant's Exhibit No. 29—(Continued)

Computation of Income Tax

Adjusted net income	\$ 42,461.30
Less: Personal exemption	1,200.00
Balance (surtax net income).....	\$ 41,261.30
Less: *Earned income credit	892.67
Balance subject to normal tax.....	\$ 40,368.63
Normal tax at 6% on \$40,368.63.....	2,422.13
Surtax on \$41,261.30	17,789.39
Total tax	\$ 20,211.52
Add: Net victory tax	1,266.46
Total income and victory tax.....	\$ 21,477.98
Income tax for 1942 recomputed.....	\$ 56,541.07
Amount of 1942 or 1943 tax whichever is larger.....	\$ 56,541.07
Forgiveness feature (not to be used if either 1942 or 1943 tax is \$50.00 or less):	
(a) Amount of 1942 or 1943 tax whichever is smaller	\$21,477.98
(b) Amount foregiven (\$50.00 or three- fourths of (a), whichever is larger)....	16,108.48
(c) Amount unforgiven	\$ 5,369.50
Total income and victory tax liability.....	\$ 61,910.57
Income tax previously determined.....	28,100.23
Deficiency in income and victory tax.....	\$ 33,810.34
Earned Income Credit:	
* (10% of 20% of \$42,390.81.....	\$ 847.82
10% of \$448.50	44.85
Total	\$ 892.67

Defendant's Exhibit No. 29—(Continued)

Explanation of Adjustments

1942-1943

It is held that during the years 1942 and 1943 a partnership existed between William A. Hammond and his father Ross B. Hammond, and that the profits therefrom should be taxed 25% to the son, and 75% to the father; also that the amounts of \$66,635.88 credited to the accounts of H. M. Mason and A. V. Petersen in 1942 and \$77,366.37 in 1943 could not be considered constructively received and therefore the two partners should be taxed upon the entire income exclusive of the credits above indicated, or a redistribution of partnership income as follows:

1942

Net income of partnership, Ross B. Hammond and Company before credit of \$86,635.88 to H. M. Mason and A. V. Petersen:	
(Report dated December 21, 1946).....	\$410,610.02
Add: Salary paid to William A. Hammond.....	7,500.00
	<hr/>
Total adjusted partnership income.....	\$418,110.02
William A. Hammond share: 25% of \$418,110.02.....	104,527.51
Amount previously reported on amended return.....	44,629.66
	<hr/>
Increase in income	\$ 59,897.85

1943

Net income of partnership, Ross B. Hammond and Company before credits of \$77,366.37 to H. M. Mason and A. V. Petersen:	
(Report dated April 12, 1947).....	\$162,063.26
Add: Salary paid to William A. Hammond.....	7,500.00
	<hr/>
	\$169,563.26
William A. Hammond share: 25% of \$169,563.26.....	42,390.91
Amount reported on original return.....	44,045.10
	<hr/>
Decrease in income	\$ 1,654.29

1942	31	44,629.66 - 7,500 1942				37 129 66
1943	31	40,657.02 - 7,500 1943	213			33 157 92
1944	31	3,711.92 - 7,500 1944				32 11 92
1945						73 49 60
1946	31	10,907.25 - 12,500	246			159 27 5
1947	31	5,938.92 - 17,500				71 00 15
1948	31	126,144.77 54,500				(1561 08)
1949	31	ck # 1442	35,344.77		35000000	7034 4 77
1950	31	50,189.48 - 35,000 -	88,533.25			15188 48
1951	31					35000000

300 31
 Paid

Portland Raising & Supply Co.
 Worcester Building

1953
 March 31
 April 9

0-148

Waterproofing walls

9190

918

1939

N. M. Mason

Aug 31		Teleph calls to N. M.	772	275
Sept 12	ck 0-5204		787	275
Oct 31		Teleph calls to N. M.	779	1575
Apr 12	ck 0-6083		995	1575
Apr 30		3300 telegrams	1000	600
May 10	ck 0-6120		108	600
Dec 31	1948	59,506.22 - 10,000 1442		49,506.22
Dec 31	1948	54,209.35 - 10,000 1443		44,209.35
Dec 31	1949	14,282.56 - 10,000 1444		4,282.56
Dec 31	1950			1,178.13
Dec 31	1951	14,542.44 - 12,500	947	2042.94
Dec 31	1952			10,140.11
Jan 14	ck #31.5		20000.00	
Jan 16		17,217.16 - 27,500		
Jan 31		17,217.16 - 27,500	67,758.22	20000.00 (60,282.84)
Jan 31			49,758.22	20666.66
Jan 31				900.00
Jan 31				49758.28
Jan 31				54738.28

Recd
32
3072

ca 7124, 1938

mail - Well Envelope Co. 2136 S. E. 7th Ave.

May 21		1000 air mail envelopes	962	
26		1000 air mail letterheads		
June 1	ck 0-4207		635	2380
Sept 25		150 - 9 1/2 x 11 1/2 H. D. 40 Brown	914	
		Knapp 200 - String Line		
		50 - 10 1/2 x 15 - H. D. 40 Brown Knapp 200		
		String Line	920	1843
Oct 10	ck 0-5824			
July 31		110 - 9 1/2 x 11 1/2 H. D. 40 Brown	1043	
Aug 8	ck 0-6244		1046	525
Jan 23		200 heavy Brown eps		
Feb 11	ck 0-6507		912	745
Mar 10		100 - 10 x 15 heavy string envelopes		
		40 Knapp -		
Apr 9	ck 0-6595		920	775
Sept 30		100 - 9 1/2 x 12 - Open Side Dan Valley		
		50 - 9 1/2 x 12 - Clasp 28	4.23	
Oct 10	ck 0-934			423
Dec 31	1948			
Jan 10	ck #1237			3085

W. Hammond - Insurance

1943 Insurance	7500 00
1944 "	31,891 02
1945 ✓	10,703 50
1946 ✓	35,328 09
1947 ✓	12,731 37

W. Hammond - Insurance

	8451.17
12705401	11,610284
18572897	28,78394
20055275	7412028
34170602	3574218
392,2672	37,68434

1942 Insurance	
1943 ✓	
1944 ✓	
1945 ✓	
1946	
1947 ✓	

Handwritten signature and calculation:
35
 3018

W. Hammond - Capital

1942 Insurance	Cap. Ins. Exp.	3712966
1943 ✓	7367476	4454516
1944 ✓	6136548	4758174
1945 ✓	566854	2500654
1946 ✓	6529569	13498524
1947 ✓	10517072	5260640

Total Paid

20059122
37677161
44709851
54722493
64756579
46536465

W. Hammond - Capital

5501039
17604284
20000412
2022034
20006458
36019393

End 1942-
1943 Insurance
1944 ✓
1945 ✓
1946 ✓
1947 ✓

DEFENDANT'S EXHIBIT No. 36

Journal Entry: J. 125

Dec. 31, 1942	Job 208	J 125	47254.58
	Job 210		53307.66
	Job 211		39670.81

Office Salaries	16467.51
W. A. Hammond, A/P overhead	37129.66
A. V. Peterson	37129.66
H. M. Mason	49506.22

[Endorsed]: No. 12073. United States Court of Appeals for the Ninth Circuit. J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, Appellant, vs. Ross B. Hammond, Appellee. Transcript of Record. Appeal from the District Court of the United States for the District of Oregon.

Filed: October 22, 1948.

/s/ PAUL P. O'BRIEN,

Clerk of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 12073

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Appellant,

vs.

ROSS B. HAMMOND,

Appellee.

MOTION

Comes now Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, and based upon affidavit moves the Court for an order extending the time for filing the record on appeal and docketing the action, granting to appellant ninety (90) days from June 18, 1948. This motion is based upon Rule 73, Rules of Civil Procedure.

Dated at Portland, Oregon, this 15th day of July, 1948.

HENRY L. HESS,
United States Attorney for the District of Oregon.

/s/ VICTOR E. HARR,
Assistant United States Attorney.

So Ordered:

/s/ FRANCIS A. GARRECHT,
Senior United States Circuit Judge.
(Affidavit of Service by Mail.)

[Endorsed]: Filed July 16, 1948. Paul P.
O'Brien, Clerk.

[Title of U. S. Court of Appeals and Cause.]

MOTION

Comes now Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, and based upon attached affidavit moves the Court for an order extending the time for filing the record on appeal and docketing the action, granting to appellant thirty (30) days from September 16, 1948. This motion is based upon Rule 73, Rules of Civil Procedure.

Dated at Portland, Oregon, this 10th day of September, 1948.

HENRY L. HESS,
United States Attorney for the District of Oregon.

/s/ VICTOR E. HARR,
Assistant United States Attorney.

ORDER

This matter coming on to be heard upon motion of Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, for an order extending the time thirty (30) days from September 16, 1948 for filing the record on appeal and docketing the action, and the Court having considered said motion and the supporting affidavit filed therewith, and being advised, it is

Ordered that the appellant be and he is hereby granted an extension of thirty (30) days from

September 16, 1948 within which to file and docket the record on appeal.

Dated at San Francisco, California, this 13th day of September, 1948.

/s/ WILLIAM DENMAN,
Chief Judge, U. S. Court of Appeals for the Ninth
Circuit.

(Affidavit of Service by Mail attached.)

[Endorsed]: Filed September 13, 1948. Paul P.
O'Brien, Clerk.

[Title of U. S. Court of Appeals and Cause.]

MOTION

Comes now Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, and based upon the attached affidavit moves the Court for an order extending the time for filing the record on appeal and docketing the action, granting to appellant thirty (30) days from October 16, 1948. This motion is based upon Rule 73, Rules of Civil Procedure.

Dated at Portland, Oregon, this 11th day of October, 1948.

HENRY L. HESS,
United States Attorney for the District of Oregon.

/s/ VICTOR E. HARR,
Assistant U. S. Attorney.
(Affidavit of Service by Mail attached.)

[Endorsed]: Filed October 14, 1948. Paul P.
O'Brien, Clerk.

[Title of U. S. Court of Appeals and Cause.]

OBJECTIONS TO MOTION FOR EXTENSION
OF TIME TO DOCKET APPEAL

Comes now the appellee above-named and objects to the granting of the motion of the appellant for an extension of time for filing the record and docketing the appeal for a period of thirty days from October 16, 1948 on the following grounds, to-wit:

1. Neither the motion nor the affidavit attached thereto and upon which the motion is predicated presents any valid reason for such extension of time.

2. That under Rule 73(g) of the Federal Rules of Civil Procedure the District Court alone is authorized to grant an extension of time for the docketing of an appeal.

This objection is based upon the affidavit of Robt. T. Jacob, verified October 14, 1948, and upon the records and files of this cause in this Court and in the United States District Court for the District of Oregon.

Dated October 14, 1948.

/s/ ROBERT T. JACOB,

/s/ S. J. BISCHOFF,

Attorneys for Appellee.

(Acknowledgment of Service.)

[Endorsed]: Filed October 15, 1948. Paul P. O'Brien, Clerk.

[Title of U. S. Court of Appeals and Cause.]

ORDER

This matter coming on to be heard upon motion of Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, for an order extending the time thirty (30) days from October 16, 1948, for the filing of the record on appeal and docketing the action, and the Court having considered said motion and the supporting affidavit filed therewith, and being advised, it is

Ordered that the appellant be, and he is hereby granted an extension to October 23, 1948, within which to file and docket the record on appeal.

Dated at San Francisco, California, this 15th day of October, 1948.

/s/ WILLIAM DENMAN,
Chief Judge, U. S. Court of Appeals, Ninth Circuit.

[Endorsed]: Filed October 15, 1948. Paul P. O'Brien, Clerk.

[Title of U. S. Court of Appeals and Cause.]

APPELLANT'S STATEMENT OF POINTS ON WHICH HE INTENDS TO RELY ON AP- PEAL AND DESIGNATION OF THE REC- ORD FOR PRINTING

Comes now J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, appellant above-named, and pursuant to Subdivision 6, Rule 19, of the Rules of the United

States Court of Appeals for the Ninth Circuit, hereby adopts the statement of points filed in the District upon which appellant intends to rely on appeal, and herewith designates the following parts of the transcript of record as prepared and certified by the Clerk of the District Court to be printed for the purposes of this appeal:

1. Complaint, filed March 16, 1946.
2. Answer, filed July 19, 1946.
3. Motion and Notice and Affidavit attached for leave to file an amended answer, filed October 17, 1947.
4. Objections to the Motion of defendant for leave to file an amended answer, and affidavit attached thereto, filed October 27, 1947.
5. Petition of the United States for leave to intervene, filed October 31, 1947.
6. Objections to petition for intervention, filed November 10, 1947.
7. Order sustaining plaintiff's objections to petition for intervention, entered and filed November 14, 1947.
8. Findings of Fact and Conclusions of Law, filed April 21, 1948.
9. Judgment, entered and filed April 21, 1948.
10. Notice of Appeal, filed June 18, 1948.
11. Motion, Affidavit and Order of the Circuit Court of Appeals, granting extension of ninety days from the date of filing Notice of Appeal to file and docket record on appeal, dated July 16, 1948, and filed July 22, 1948.

12. Motion, Affidavit and Order of Circuit Court of Appeals granting extension of thirty days from September 16, 1948 within which to file and docket record on appeal, dated September 13, 1948, filed October 19, 1948.

13. Order of the Circuit Court of Appeals granting extension to October 23, 1948, to file and docket record on appeal, dated October 15, 1948; filed October 19, 1948.

14. Statement of Points on which Defendant Intends to Rely on Appeal. (D.C.)

15. Order to send trial exhibits.

16. Designation of Contents of Record on Appeal. (D.C.)

17. Entire transcript of testimony and proceedings of the trial.

18. The following exhibits:

Plaintiff's Exhibit 1—Letter dated July 7, 1938, Commissioner of Internal Revenue to Ross B. Hammond.

Plaintiff's Exhibit 3—Agreement and Articles of Partnership dated Feb. 3, 1942, between Ross B. Hammond and William A. Hammond.

Plaintiff's Exhibit 4—Agreement dated Feb. 3, 1942, between Ross B. Hammond and Henry M. Mason.

Plaintiff's Exhibit 5—Agreement dated Feb. 3, 1942, between Ross B. Hammond and A. V. Petersen.

Plaintiff's Exhibit 6—Only that part of the exhibit consisting of the income tax returns of Ross B. Hammond for the years 1942 and 1943.

Defendant's Exhibit 26—Original income tax returns of A. V. Petersen for 1942 and 1943.

Defendant's Exhibit 27—Income tax returns of Henry M. and Elizabeth R. Mason for 1942 and 1943.

Defendant's Exhibit 28—Letters dated March 3, 1938, taxpayer to Commissioner; March 29, 1938, Commissioner to taxpayer; April 5, 1938, taxpayer to Commissioner; April 25, 1938; Commissioner to taxpayer; and May 9, 1938, taxpayer to Commissioner.

Defendant's Exhibit 29—Statement in re Ross B. Hammond for the years 1942 and 1943, and statement in re William A. Hammond for the years 1942 and 1943.

Plaintiff's Exhibit 31—Subsidiary Ledger Account A. V. Petersen.

Plaintiff's Exhibit 32—Subsidiary Ledger Account H. M. Mason.

Plaintiff's Exhibit 35—Sheet from Subsidiary Ledger in re Capital Account.

Defendant's Exhibit 36—Transcript of Journal Entry 125.

All of the other exhibits are either unnecessary for consideration of the points upon which appellant intends to rely upon appeal, are voluminous and are otherwise not susceptible for printing but

will be available for inspection by the Court as they have been transmitted to the Circuit Court in their original form.

19. This Statement and Designation.

Dated this 10th day of December, 1948.

/s/ HENRY L. HESS,
United States Attorney.

/s/ VICTOR E. HARR,
Assistant U. S. Attorney.

/s/ THOMAS R. WINTER,
By /s/ VICTOR E. HARR,
Special Assistant to the U. S. Attorney.

(Acknowledgment of Service.)

[Endorsed]: Filed December 13, 1948. Paul P. O'Brien, Clerk.

[Title of U. S. Court of Appeals and Cause.]

DESIGNATION OF ADDITIONAL PARTS OF
THE RECORD TO BE PRINTED

Comes now the appellee above-named and designates the following additional parts of the record to be printed:

1. Plaintiff's Exhibit 12.
2. Plaintiff's Exhibit 13.
3. Plaintiff's Exhibit 14.
4. Plaintiff's Exhibit 15.
5. Plaintiff's Exhibit 16.
6. Plaintiff's Exhibit 17.
7. Plaintiff's Exhibit 18.
8. Plaintiff's Exhibit 19.
9. Plaintiff's Exhibit 20.

Appellee objects to the printing of the following portions of the transcript of the testimony on the ground that all of said testimony pertains to the issue of partnership only. In Appellant's statement of points on which he intends to rely on the appeal he does not challenge the Findings of Fact and Conclusions of Law of the Court below in so far as it determines the existence of the partnership between Ross B. Hammond and William A. Hammond. Therefore, all testimony pertaining thereto will be an unnecessary incumbrance of the record.

The parts of the transcript to be omitted are as follows:

1. Omit last two lines of page 27 to and including the first 10 lines on page 33.
2. Omit the last 5 lines on page 80 to and including the first 7 lines on page 102.
3. Omit last line on page 117 to and including the first 14 lines on page 119.
4. Omit the last 11 lines on page 161 to and including the first 17 lines on page 163.
5. Omit the last 19 lines on page 165 to and including page 176.
6. Omit last 23 lines on page 178 to and including the first 4 lines on page 191.
7. Omit page 195 to and including the first 19 lines on page 198.
8. Omit last two lines on page 200 to and including the first 3 lines on page 202.
9. Omit the last 12 lines on page 211 to and including page 226.
10. Omit last 16 lines on page 229 to and including the first 5 lines on page 233.

11. Omit all of page 251 except the first line to and including the first 14 lines on page 266.

12. Omit page 280 to and including first 6 lines on page 282.

13. Omit last 23 lines on page 310 to and including page 313.

14. Omit page 399 to and including page 409.

Dated December 18, 1948.

/s/ R. T. JACOB,

/s/ S. J. BISCHOFF,

Attorneys for Appellee.

/s/ VICTOR E. HARR,

Of Attorneys for Appellant.

[Endorsed]: Filed December 27, 1948. Paul P. O'Brien, Clerk.

No. 12073

In the United States
Circuit Court of Appeals
for the Ninth Circuit

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Appellant,

v.

ROSS B. HAMMOND,
Appellee.

On Appeal from the United States District Court
for the District of Oregon

BRIEF FOR THE APPELLANT

THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
A. F. PRESCOTT,
EDWARD J. P. ZIMMERMAN,
*Special Assistants to the
Attorney General.*

HENRY L. HESS,
United States Attorney.
VICTOR E. HARR,
Assistant United States Attorney.

FILED

APR 7 - 1949

GLASS-KEYSTONE PRESS

PAUL R. O'BRIEN,
CLERK

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II. The District Court erred in finding that amounts set aside under the Mason-Peterson profit-shar- ing agreements were properly accrued deduc- tions in the taxable year	24
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CITATIONS

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No. 12073

In the United States
Circuit Court of Appeals
for the Ninth Circuit

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Appellant,

v.

ROSS B. HAMMOND,
Appellee.

On Appeal from the United States District Court
for the District of Oregon

BRIEF FOR THE APPELLANT

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OPINION BELOW

The opinion of the District Court (R. 19-39) is reported in 80 F. Supp. 212.

JURISDICTION

This appeal involves federal income taxes for the taxable year 1943. The taxes in dispute were paid as follows: \$157,146.90 on August 17, 1945. (R. 21.) Claim for refund was filed on August 22, 1945 (R. 21), and the Commissioner did not within six months either allow or reject the claim. (R. 21). Within the time provided in Section 3772 of the Internal Revenue Code and on March 16, 1946, the taxpayer brought an action in the District Court for recovery of the taxes paid. (R. 2-4.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1340. The judgment was entered on April 21, 1948. (R. 40-41.) Within sixty days and on June 18, 1948, a notice of appeal was filed. (R. 41-42.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether the method of accounting employed by the Commissioner in determining deficiency in income tax was authorized under Section 41 of the Internal Revenue Code.

This in turn depends upon a determination of whether taxpayer received from the Commissioner permission to report income on the accrual basis, whether in fact the accrual method was employed, and whether taxpayer's accounting basis "does not clearly reflect the income" within the meaning of Section 41 of the Code.

2. Whether the setting aside of large sums in accordance with profit-sharing agreements with two employees, whereby the excess of certain amounts was to remain in the company, was an allowable deduction as business expense under Section 23 (a) (1) and therefore properly accrued in the taxable year 1943.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are to be found in the Appendix, *infra*.

STATEMENT

The facts herein, substantially as found by the District Court, and insofar as material to the issues on appeal, may be summarized as follows:

Taxpayer is an individual, resident of Oregon. On July 27, 1945, the Commissioner assessed against taxpayer a deficiency in income and surtaxes for the taxable year 1943,

in the sum of \$145,537.77, together with interest of \$11,609.13, totalling \$157,146.90. Taxpayer paid in cash \$150,592.88 of this, the remainder being paid by credit allowed for refund on an overassessment for 1941. (R. 20-21.)

On August 22, 1945, taxpayer filed a claim for refund of the additional taxes paid, and subsequent to six months thereafter filed suit in the United States District Court for the District of Oregon, the Commissioner not having approved nor rejected the claim. (R. 21.)

The deficiency in income and surtaxes was based upon the report of Revenue Agent, W. G. Williams (R. 21, 596), in part upon the refusal of the Commissioner to recognize a partnership between taxpayer and his son¹ and in part upon the Commissioner's rejection of the partnership accounting method. (R. 21-22.)

Prior to the tax year 1938, taxpayer conducted his contracting business in the name of a corporation which kept its books on the percentage of completion basis. Taxpayer kept his individual accounts on the cash basis. As of the end of the year 1938, the corporation was dissolved, and until the formation of the partnership between father and son, taxpayer conducted the business in his own name. When the corporation was dissolved, it had been engaged in constructing the State Capitol Building at Salem, Oregon. Upon dissolution, taxpayer individually completed

¹ This determination is not in issue upon this appeal.

the project. In 1937, the corporation had reported the income from the project on the percentage of completion basis. (R. 25.)

The court below found that taxpayer applied to the Commissioner for permission to adopt individually the accrual basis of accounting, with the exception that income to be reported from the state capitol project was to be reported on the percentage of completion basis. The court also found that in 1938 the Commissioner granted such permission, and that taxpayer thereafter maintained his accounts and reported his income in the manner so permitted.² The court also found that in all years subsequent to 1938 the father and son partnership maintained the accrual method of accounting, making no change in method. The court found that the accounts clearly reflected the income of the partnership. (R. 26-27.)

The court found that income in the tax years in question was properly reported and deductions properly taken, and found that there was no basis either in fact or law for the rejection of taxpayer's method of accounting and that the method of accounting employed by the Commissioner to reflect the income of the partnership was an improper method of accounting because based partly on an accrual, partly

2 The court found that taxpayer reported on the accrual basis in and after 1938, but that in 1938 he reported the remainder of the State Capitol Building project on the percentage-of-completion basis. (R. 26.)

upon a percentage of profit, and in part upon a completion of contract basis. (R. 27.)

The Commissioner disputes the findings set out in the two preceding paragraphs.

In addition to what may be termed the "accounting issue," there is in issue a profit sharing agreement between taxpayer and two of his employees. The taxpayer on February 3, 1942, entered into such an agreement with one Henry M. Mason. (R. 28.)

Under the agreement, Mason was to be paid 20% of the profits of the company for each calendar year, after deduction of expenses but before deduction of income taxes. The parties agreed that the business needed large working capital and agreed that Mason's compensation was to be paid by a drawing account of \$500 per month, but that Mason was not to be permitted to draw more than \$10,000 in any one year. Funds in excess of that amount were to be permitted to remain in the company, for use as working capital, bearing no interest. The agreement provided for cancellation, and provided that if Mason left the company and desired to withdraw his earnings, one year's notice of demand for such funds must be given taxpayer. If Mason should cancel the agreement or resign, the drawing account of \$500 monthly was to be his entire compensation for that calendar year. Were the drawing account to exceed 20% of the profits, it was to be charged against any amounts

accrued to Mason's account under the agreement. The final paragraph of the agreement was an agreement that the contract was one of employment only, that Mason received thereby no interest in the business, all payments to represent compensation for services rendered. (R. 28-32.) Taxpayer entered into an agreement on the same date with one A. V. Peterson, providing similarly, but providing for a \$400 monthly drawing account, with a maximum annual withdrawal of \$7,500 yearly. (R. 32.)

In the tax year 1942, the share of profits earned by Peterson and Mason in accordance with the terms of the contracts with taxpayer amounted to \$86,635.88; in the tax year 1943, \$77,366.37. These amounts were computed upon the same accounting method used to compute taxpayer's profits, and credited against Mason's and Peterson's accounts. (R. 32-33.)

The court below found that the profits accrued to Mason and Peterson, but paid subsequently to 1942-1943, were proper deductions in the tax years as expenses in taxpayer's return. (R. 33.)

The court also found that when the revenue agent examined taxpayer's books, resulting in the report noted, *supra*, he had knowledge of all the facts pertaining to deductions under the profit-sharing agreements and that he examined into their propriety but did not disallow or reject such deductions, nor did the Commissioner reject the

deductions as a basis for assessment of deficiency. (R. 33-34.)

The action for refund was commenced on March 16, 1946. On July 19, 1946, the Collector interposed his answer, but did not set up any counterclaim, set-off, or defense based upon the Mason-Peterson deductions. But on October 18, 1947, the Collector moved for leave to file an amended answer in which it was claimed for the first time that the Mason-Peterson deductions should not have been allowed. Taxpayer objected on the ground that no cause was shown why such matters should not have been referred to at an earlier date, that there was no showing of due diligence, that the amendment set out a new cause of action, and that the set-off termed "Additional Defense" was barred by the statute of limitations contained in the Internal Revenue Code. The court denied the Collector's motion upon the grounds urged. (R. 18-19, 34-35.)

But upon trial of the action, the court permitted evidence upon the Mason-Peterson deduction issue, subject to taxpayer's objections. Thereafter, the court found that taxpayer's objections were well taken and also found upon the merits that the share of profits credited on taxpayer's books and by the partnership to Mason and Peterson and accrued as expense and deductions were properly taken. (R. 35.)

The court below found that the deficiency assessed and

collected was illegal and granted judgment for taxpayer, April 21, 1948. (R. 36, 40.)

The court also granted a judgment dismissing the Collector's suit for \$6,554.03, which had been consolidated with the action at bar. This action had been brought for the refund credit allowed for 1941, noted *supra*, with which taxpayer had paid part of the deficiency assessed for 1943. Taxpayer therefore was adjudged entitled to recover but \$150,592.88, plus interest thereon. (R. 36-37.)

The court's conclusions of law are set out at R. 37-39.

The Collector filed his notice of appeal June 15, 1948. (R. 41.) Taxpayer moved to dismiss the appeal on the ground that the Collector failed to file the transcript for docketing in this Court within the time provided by Rule 73(g) of the Federal Rules of Civil Procedure. This Court denied the motion. *Maloney v. Hammond*, 171 F. 2d 225.

STATEMENT OF POINTS TO BE URGED

1. The District Court erred in finding and concluding that taxpayer's method of accounting clearly reflected taxable income.
2. The District Court erred in finding and concluding that taxpayer was entitled to deduct a percentage of his profits from the partnership under profit-sharing agreements with two of his employees.

3. The District Court erred in denying Collector's motion to amend his answer and plead as a set-off that taxpayer had not overpaid his taxes on the grounds that he failed to include in his taxable income for the period involved all of his income from the partnership.

4. The District Court erred in finding and concluding that the Commissioner of Internal Revenue authorized taxpayer to file his federal income tax returns on the accrual basis of accounting and in not concluding that the Commissioner of Internal Revenue authorized taxpayer to report his long-term contracts on the percentage of completion basis.

5. The District Court erred in not finding and concluding that taxpayer maintained stock piles of material which were not reflected in reporting net income from long-term contracts.

SUMMARY OF ARGUMENT

Taxpayer's method of accounting distorts his income. He did not follow the method authorized by the Commissioner, accrual coupled with the reporting of long-term contracts on a percentage of completion basis. The attempted accrual method used by taxpayer did not clearly reflect his income and the Commissioner therefore properly exercised his broad discretion to recompute taxpayer's income in order

that it might clearly reflect income. Such determination should stand in the absence of taxpayer's showing that his method does clearly reflect income. Taxpayer failed to follow the Regulations applicable to percentage of completion accounting in that he failed to keep inventories and failed to accrue uncompleted work. Accordingly, the Commissioner's method of accounting, being the best available under the circumstances to clearly reflect taxpayer's income year by year, should be allowed to stand, taxpayer not having sustained his burden of proving overpayment of tax.

Taxpayer did not properly accrue deductions for amounts set aside to be paid Mason and Peterson under their profit-sharing agreements. The amounts so credited were not constructively received, nor were they fixed and definite obligations, for there was no certainty that any amounts credited might ever be paid over. Moreover, assuming *arguendo* that the amounts might properly be accrued, the amounts credited could not be deducted until paid under the provisions of the Internal Revenue Code providing for contributions of an employer under a deferred payment plan. The problem of the Mason-Peterson deductions is a proper subject of appeal, in that the District Court abused its discretion in denying Collector's motion to amend his answer to present the question and in that the District Court necessarily had to reach the merits to decide whether or not taxpayer had overpaid his tax.

ARGUMENT

I

The District Court Erred in Accepting Taxpayer's Method of Accounting and Rejecting Commissioner's.

Under Section 42 of the Internal Revenue Code (Appendix, *infra*), taxpayer is bound to account annually or on a fiscal year basis for all his income. This he may do by one of several methods—accrual, cash receipts and expenditures, or on a long-term basis, as provided in Treasury Regulations 94, Article 42-4 (Appendix, *infra*).³

3 Subsequent Regulations deal with the same subject matter, and, for the purposes of the case at bar are the same. Treasury Regulations 111, Section 29.42-4; Treasury Regulations 103, Section 19.42-4; Treasury Regulations 101, Article 42-4. Article 42-4 provides in part that as to long-term contracts:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion.
 * * * There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return. * * *

* * * *

(Footnote 3 continued)

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this article only after permission is secured from the Commissioner as provided in article 41-2.

Article 41-2 and corresponding subsequent Regulations require the permission of the Commissioner whenever a taxpayer's accounting method is changed.

The taxpayer contended below that he adopted the accrual method of accounting, in accordance with permission granted by the Commissioner, upon dissolution of his corporation, and that his method of accounting fairly and clearly reflected his income for the taxable years involved. The District Court so found.

It is the Collector's position that the findings of the court below permit taxpayer to utilize a system of accounting which distorts his income and inhibits an orderly collection of income tax.

We contend that the taxpayer, in following the method he used, did not use the system he requested and received permission to use from the Commissioner, except in the first year to which the permission applied. Taxpayer actually received permission to use an accrual basis coupled with permission to report long-term contracts on a percentage-of-completion basis. He did not follow the method so permitted. Even assuming *arguendo* that taxpayer had the right to use the accrual system alone and used it, such a method did not clearly reflect taxpayer's income. As a

result, the Commissioner, as he is authorized to do, adopted his own determination as to the accounting method to be followed for taxpayer's income for the taxable years involved. We contend that the court erred in rejecting this method of the Commissioner's. In this connection we point out that Section 41 of the Internal Revenue Code (Appendix, *infra*) provides:

* * * if the method employed [by the taxpayer] does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

The problem of which was the proper method of accounting necessarily depends upon the facts of each case, and must be resolved by an examination of the record.

During the years involved taxpayer, and subsequently taxpayer and his son as partners, entered into several long-term contracts. These were of varying types, depending upon the terms of compensation—fixed fee, lump-sum, or cost-plus basis (R. 149.) There was also one characterized by taxpayer as "entirely different." (R. 149, *et seq.*) All the contract accounts were kept on an attempted accrual basis. In substance, taxpayer accrued all labor and material as acquired. As the work progressed on these contracts, taxpayer or someone on his staff periodically estimated the work that had been done, and submitted the estimates to

the owners' engineers or architects for approval. Thereafter, the owners were billed. (R. 155-159; 232-235.) An effort was made to collect as much as possible as the work progressed. (R. 162, 176, 233, 405.) Generally, when materials were received and delivered to the project, the owners were billed therefor. (R. 234-235, 245-246, 338-340.) Billings for materials were not delayed until the materials were incorporated in the construction. On some contracts, materials not incorporated into the project could not be billed while merely stored on the job. (R. 246.) Yet no inventories of materials on hand were maintained in any case. (R. 169, 177, 181-182, 245, 247, 309-310.) Frequently, materials on hand in December would not enter into billings made until the subsequent year, nor would work done, if no estimate were made before the end of the year, as was frequently the case. (R. 310-315, 318-319.) Yet expenses would be accrued for this period, expenses for materials being accrued upon receipt thereof. (R. 249, 319.)

Under the fixed-fee and cost-plus contracts, 90% of the fixed fee was billed and paid as it accrued, in monthly installments based on estimates of percentage of completion. The balance was paid upon completion and final architectural or engineering acceptance. Monthly payments, up to 90% of the contract price, were made under lump-sum contracts for labor and materials put into the work and 75% of all staple materials stored at the site, up to the first

day of the month as estimated by the architect-engineer. The remainder was paid upon final certificate.

The revenue agent making his investigation determined that subsequent to 1938, taxpayer had not kept his books and reported income on a percentage-of-completion basis, but had instead used an "attempted accrual basis." (R. 600.) And accordingly proper accruals were not entered in the contract accounts in the books, income not being properly accrued, nor cost of materials set up as a prepaid expense. He felt that the distortion of income present in the years under consideration was primarily due to failure to keep inventories of materials on hand but not yet incorporated in the construction work being done. (R. 442, 462.) An inventory would have been required under Article 42-4 of Treasury Regulations 94, had taxpayer properly reported on the percentage-of-completion basis. He found a marked distortion of income and determined that to recompute the income for the years in question in accordance with a true percentage-of-completion method, or in accordance with a true accrual basis, would entail a prohibitive amount of time. Accordingly, he attempted to devise a retrospective method of accounting which would fairly reflect the income of the years under examination. To do this he applied the ratio of profit to total income received on each contract to the yearly income received in each case. His recomputation rests upon such basis.

Admittedly, the method the revenue agent employed is not one explicitly provided for by the Regulations, nor by the Internal Revenue Code. But it does narrow the distortion of profits reported in the several years under the method employed by taxpayer. The Commissioner has broad discretion in making a recomputation clearly to reflect income, which may be reviewed only when abuse is shown. *William Hardy, Inc. v. Commissioner*, 82 F. 2d 249 (C. A. 2d), citing *Brown v. Helvering*, 291 U. S. 193, and *Lucas v. American Code Co.*, 280 U. S. 445; *In re Newman*, 94 F. 2d 108 (C. A. 6th). *Carver v. Commissioner*, 10 T. C. 171, appeal pending (C. A. 6th). The Commissioner is not bound by stereotyped methods of accounting, but he must have some leeway in determining, as he is bound to do, whether income is properly reflected. *William Hardy, Inc. v. Commissioner*, *supra*. Therein the court also states that the Commissioner's acceptance of returns on the basis he seeks to change is not binding upon him. Accord, *Carver v. Commissioner*, *supra*. And in the absence of a showing by the taxpayer that taxpayer's method accurately reflects income for the years in question, it would seem that the Commissioner's method should be sustained. Taxpayer failed to make such a showing.

Taxpayer principally took the position that he was properly returning income on the accrual basis, and that thereunder it was unnecessary for him to take into account mat-

materials on hand and not yet used. The court found that the Commissioner had authorized taxpayer to report income on the accrual basis, but we contend on the contrary that the Commissioner authorized him to report on accrual, with long-term contracts reported on the percentage of completion basis. This would not be inconsistent permission, nor would it produce a "hybrid" system of accounting.

The taxpayer first wrote to the Commissioner requesting (R. 633), "In accordance with requirements of Article 42-4, Regulations 94," that he be permitted to change his accounting basis. Prior to that time, the corporation had been reporting on accrual plus percentage-of-completion basis. In the letter, taxpayer stated that the corporation had been dissolved and the business transferred to him as a sole proprietorship. The purpose of the letter was stated to be an attempt to take every precaution to see (R. 633-634)—

that the method heretofore employed by the corporation is perpetuated and that the new ownership is permitted to file upon the same basis as that used by the corporation.

The letter states in addition that in view of the fact that the corporation's books had been kept on an accrual basis, the individual books would be kept on a similar basis, and returns accordingly made on an accrual basis.

Taxpayer's attorney attempted to explain away the request for permission to report on a percentage-of-completion

basis on the ground that the letter was written by a layman. But taxpayer testified below that "very probably it was dictated" by his counsel. (R. 203.) This would be consistent with taxpayer's admitted ignorance of accounting bases and tax regulations. (R. 160-161, 202.) Since taxpayer thought the corporation was on a "finished basis,"⁴ (R. 161), it is hardly likely he would write a letter clearly identifying and indicating knowledge of the percentage-of-completion basis and applicable Regulations.

The Commissioner, in answer, advised taxpayer that (R. 635)—

to the extent that your income is derived from long-term contracts, as defined in article 42-4 of Regulations 94, you may report your gross income from such contracts upon either of the two bases set forth in that article * * *.

Replying to the Commissioner's letter, taxpayer stated (R. 636):

I requested permission to report income from contracts, as an individual, on a *percentage-of-completion* basis, as the corporation had previously been doing, and to keep all accounts and make all returns on an accrual basis. Your reply of March 29th, grants permission to me to report income from contracts as the

⁴ This, despite the fact that it was admittedly on the percentage-of-completion basis. The court also found as much. (R. 25.)

corporation had been doing, but makes no statement regarding keeping all accounts on an accrual basis. (Emphasis supplied.)

He then stated that the corporation had been keeping its books and filing its returns on an accrual basis while he personally had been on the cash basis, that the corporation had been dissolved, that all future returns would be made as an individual, and that since his main income was from the construction business (R. 637)—

which has been kept on an accrual basis, we, therefore, request definite permission to make all future returns of Ross B. Hammond as an individual on the same basis as the corporation had previously made returns, which is the accrual basis.

After requesting further information, the Commissioner wrote taxpayer granting permission to report his income on the accrual instead of the cash basis, beginning with the tax year ending December 31, 1938. (R. 518-519.) As the court below found, taxpayer in and after 1938 reported his income on the accrual basis, with the exception that the tag end of the State Capitol Building contract in 1938 was reported on the percentage-of-completion basis.⁵ (R. 26.)

5 It is not unworthy of note that the first letter of the Commissioner discussed in the text (R. 634-635), points out to taxpayer that whatever method is first followed must thereafter be followed unless subsequent permission to change is granted by the Commissioner.

The only logical interpretation to be put on this correspondence is that taxpayer wanted to change from the cash to the accrual basis, but still wanted to report long-term contracts as the corporation had been doing prior to dissolution, on the percentage-of-completion basis. His actions in 1938 bear this conclusion out. His reports in subsequent years do not, but it is unnecessary that they do, in view of the accounting method employed for the return for 1938. The District Court's conclusion that the Commissioner authorized straight accrual accounting seems clearly erroneous therefore and should be reversed.

Accordingly, under Article 42-4 of Regulations 94, taxpayer should have kept an inventory of stock-piles over the years in question, which he did not. Further, in accordance with that article, if—

it is found that the taxable net income * * * has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

For "the method employed by the taxpayer is never conclusive." *Brown v. Helvering, supra* (p. 203).

When the revenue agent investigated, he found that taxpayer purportedly kept his books on an accrual basis, but that actually this basis was a hybrid, neither a true accrual basis nor a true percentage-of-completion basis. No inventories had been made; no consideration was given to work which had not been completed but was in progress

at the end of the year, nor to equipment or material which had been accrued on the books but not used. Article 42-4 and subsequent Regulations dealing with the same subject specifically require such accounting practices.

It would seem, moreover, that inventory of stock piles and accruing of uncompleted work are vital to clear reflection of income on long-term contracts.⁶ If stock piles and unbilled work are not accrued or taken account of, it is clear that a taxpayer may readily throw income into the year which is not profitable to him. Or, if as taxpayer proceeded here, materials are accrued as expense when delivered to the job, expense may be incurred in years of high income by way of materials procured for a subsequent year's operation. Such a distortion would seem to be indicated by taxpayer's Troutdale project.⁷

The revenue agent did not change the figures of in-

6 It was admitted at trial that in any construction project there was a considerable amount of work at the end of the year which could not be billed and would therefore not be accrued under taxpayer's method of accounting. (R. 176-177; 310-315; 318-319.) On some jobs admittedly there was a stock pile. (R. 176-177.)

7 In 1941 taxpayer reported gross income of \$59,000 and showed a profit of nearly \$24,000. The next year showed a loss of over \$20,000 against a gross income of over \$1,000,000. The third year profit was \$94,000, gross nearly \$275,000. Other projects showed a similar, though lesser, distortion. (R. 612-618.)

come shown on taxpayer's books and returns. He merely shifted the income to a given year in accordance with the percentage of which the contracts had been completed in that year. This corresponds with the requirement of Sections 41 and 42 of the Internal Revenue Code, which clearly contemplate clear reflection of income for each taxable period rather than the eventual reporting of all income received. Cf. *Security Mills Co. v. Commissioner*, 321 U. S. 281. The fact that true income may eventually be returned is irrelevant, and a dangerous consideration if tax rates fluctuate. The Commissioner is therefore empowered, in reaccounting a taxpayer's income clearly to reflect income, to seek a clear representation for each year involved.

The Commissioner's method is not explicitly set forth in the Code or in the Regulations. But taxpayer is not entitled to recover upon the mere showing that an unprescribed method has been used by the Commissioner in recomputing the tax. His is the burden to show that he has overpaid his tax. *Lewis v. Reynolds*, 284 U. S. 281, 599.⁸ It might be suggested that the Commissioner's method is inferior to taxpayer's in that every so often, a recomputation must be made. This criticism is invalid. As the revenue agent indicated, the Commissioner's recomputation does not repre-

8 In this connection, the discussion *supra*, of the Commissioner's broad discretion in the method to be used in recomputation is pertinent.

sent a permanent basis of accounting. (R. 601.) The method used was used because it was too late, the time requirement too great, to recompute taxpayer's income on a true accrual or a true percentage-of-completion basis. It was the best method available, and should therefore be upheld.

II

The District Court Erred in Finding that Amounts Set Aside Under the Mason-Peterson Profit-Sharing Agreements Were Properly Accrued Deductions in the Taxable Year.

Under their contracts with taxpayer neither Mason nor Peterson had an unrestricted right to demand payment of the amounts credited to their accounts. There is no question but that they did not constructively receive income in the taxable year as a result of their accounts being credited by taxpayer. Nor did either of them report as income the amounts so credited and sought by taxpayer to be accrued.

The problem of whether taxpayer properly accrued and therefore properly deducted the amounts set aside over and above the monthly drawing accounts and yearly maxima provided in the contracts depends upon whether the amounts were properly accrued within the meaning of Section 43 of the Internal Revenue Code. (Appendix, *infra*.) See also, Treasury Regulations 111, Section 29.43-1. The cases apropos to the problem turn on the question of whether

the compensation sought to be deducted is contingent or definite, or, in other words, whether taxpayer's liability to his employees is so conditioned as to make payment or amount uncertain. *Willoughby Camera Stores v. Commissioner*, 125 F. 2d 607 (C.A. 2d); *Commissioner v. Brooklyn R. S. Corp.*, 79 F. 2d 833 (C.A. 2d); *S. Naitove & Co. v. Commissioner*, 32 F. 2d 949 (C.A. D.C.); *Field & Start, Inc. v. Commissioner*, 17 B.T.A. 1206, affirmed, 44 F. 2d 1014 (C.A. 2d), certiorari denied, 283 U. S. 826. Compare *Kaufman Department Stores v. Commissioner*, 34 F. 2d 257 (C.A. 3d.)

It is clear from the agreements that Mason's and Peterson's deferred compensation, the amounts plowed back into the business, were not definite obligations of taxpayer. They were in fact contingent. Although each year, sums certain might be accrued to the credit of the two employees, these sums were subject always to being cut down when their percentages of the profits failed to match the amounts they were entitled to draw. As opposed to the *Kaufman Stores* case, the cutting down was not contingent upon there being losses, but merely upon net profits falling below a certain amount. Furthermore, even though either employee could cancel his agreement with taxpayer, the cancellation could not effect a withdrawal of amounts accrued to the employee's credit except subject to a year's notice, which gave the contingency full opportunity to operate to his dis-

advantage. Fundamentally, the employee's additional compensation was faced with two contingencies—his remaining in the business and the continued success of the business. In such circumstances, it would certainly seem improper to allow deductions by way of accrual for the amounts set aside, even though in the particular case the contingencies never destroyed the credit balances held for the two employees.

Even assuming, for the sake of argument, that the sums set aside for Mason and Peterson were properly accruable, Section 23 (p) (1) (D) of the Internal Revenue Code (Appendix, *infra*) would bar the deduction. Although Section 23(p) is headed "Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan," even where payment of compensation is deferred only as to a portion of taxpayer's employees, the section would seem to apply.

Section 23 (p) (1) provides that "if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation", it shall be deductible only in the year in which paid, if the plan is not included in paragraphs (A), (B), or (C) of the section. These set out plans and limitations upon percentages of profits which can be set aside. It would seem a fair conclusion that any other agreement deferring the receipt of compensation is covered by paragraph (D). The legislative

history of the section bears out such a conclusion. See S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 140-141 (1942-2 Cum. Bull. 504, 609).

Section 23 (p) (1) provides moreover for the absence of a plan, wherein it states:

If there is no plan but a method of employer contributions or compensation has the effect of a * * * profit-sharing * * * or similar plan deferring the receipt of compensation, this paragraph shall apply as if there were such a plan.

It is clear that the agreements with Mason and Peterson have "the effect" of a profit-sharing plan, although they do not extend to all of taxpayer's employees. Accordingly, deductions for payments thereunder are not properly accrued until there is payment of the amounts sought to be deducted, under paragraph (D) of the section.

The District Court refused to permit the Collector to amend his answer to set up affirmatively the question of the deductibility of the amounts set aside for Peterson and Mason. The court's decision rests in this respect in its sound discretion under Rule 15(a) of the Federal Rules of Civil Procedure. The rule, however, provides that leave to amend is freely to be given when justice so requires. The word "freely" was used advisedly to obviate technicalities. 1 Moore's Federal Practice, Section 15.06, p. 806. Either party, moreover, is privileged to amend. *McDowall v. Orr*

Felt & Blanket Co., 146 F. 2d 136 (C.A. 6th); *Hall v. Gordon*, 128 F. 2d 461 (C.A. D.C.); *Frank Adam Electric Co. v. Westinghouse Elec. Mfg. Co.*, 146 F. 2d 165 (C.A. 8th). It is our position that the court abused its discretion in denying Collector's motion to amend which would fairly have presented the issues involved to the court.

One reason the court gave for its action was the bar of the statute of limitations. This reasoning is erroneous, for where "no new assessment can be made, after the bar of the statute has fallen, the taxpayer, nevertheless, is not entitled to a refund unless he has overpaid his tax." *Lewis v. Reynolds*, *supra*, p. 283. As the Supreme Court has said further, in *Niles Bement Pond Co. v. United States*, 281 U. S. 357, 361:

But the presumption is that taxes paid are rightly collected upon assessments correctly made by the Commissioner, and in a suit to recover them the burden rests upon the taxpayer to prove all the facts necessary to establish the illegality of the collection.

The burden is not upon the Commissioner to show present ability to collect the deficiency assessed.

Irrespective, moreover, of whether or not the court below abused its discretion in denying Collector's motion to amend, it was required to pass upon the merits of the Mason-Peterson deductions, in order to determine whether, on the authority of *Lewis v. Reynolds*, *supra*, taxpayer had over-

paid his tax. Not only did the court have to pass upon the merits but in denying a motion to amend which would have presented those merits the court abused its discretion.

CONCLUSION

The decision of the District Court that taxpayer should recover his payment of deficiency assessed for 1943 was erroneous and should be reversed.

Respectfully submitted,

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April, 1949

APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 162 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(p) *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.*—

(1) *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent:

* * * * *

(D) In the taxable year when paid, if the plan is not one included in paragraphs (A), (B), or (C), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

* * * * *

If there is no plan but a method of employer contributions or compensation has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, this paragraph shall apply as if there were such a plan.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23)

SEC. 41. GENERAL RULES.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1946 ed., Sec. 41)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such

amounts are to be properly accounted for as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 42)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 43)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 42-4.⁹ *Long-term contracts*.—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term "long-term contracts" means building, installation, or construction

9 Subsequent Regulations dealing with the same subject are the same in so far as they deal with the case at bar. Treasury Regulations 111, promulgated under the Internal Revenue Code, Sec. 29.42-4; Treasury Regulations 103, promulgated under the Internal Revenue Code, Sec. 19.42-4; Treasury Regulations 101, promulgated under the Revenue Act of 1938, Art. 42-4.

contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this article only after permission is secured from the Commissioner as provided in article 41-2.

In the United States
COURT OF APPEALS
for the Ninth Circuit

J. W. MALONEY, United States Collector
of Internal Revenue for the District of
Oregon,

Appellant,

v.

ROSS B. HAMMOND,

Appellee.

On Appeal from the United States District Court
for the District of Oregon.

BRIEF FOR THE APPELLEE

FILED

MAY - 9 1949

PAUL P. O'BRIEN,

CLERK

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In the United States
COURT OF APPEALS
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J. W. MALONEY, United States Collector
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Oregon,

Appellant,

v.

ROSS B. HAMMOND,

Appellee.

On Appeal from the United States District Court
for the District of Oregon.

BRIEF FOR THE APPELLEE

STATEMENT OF THE CASE

On July 27, 1945, the Commissioner of Internal Revenue assessed against appellee a deficiency in income and surtaxes for the taxable year 1943 in involving the consolidated return for the tax years 1942 and 1943 (necessitated by the forgiveness tax act), in the sum of \$157,146.90 principal and interest.

The deficiency was predicated on two grounds:

1. Denial of the existence of the partnership between appellee and his son William;
2. Denial that appellee had the right to adopt and inaugurate the accrual method of accounting in the tax years in question, and that he should have kept his accounts and reported income on the "percentage of completion" basis.

Appellee paid the tax and brought this action for refund.

Both issues were decided in the court below adversely to the Commissioner. The partnership issue has been abandoned by appellant on this appeal.

With respect to the issue involving the accounting method, there is no issue of fact as to amount of "gross income" accrued and reported and the "deductions" accrued and reported in each tax year. The issue involves only the method of **computing** the "net income" therefrom for each tax year.

More than a year and a half after the action was commenced, and fifteen months after the answer was filed, appellant attempted to introduce a **set-off** against the claim for refund by a motion for leave to file an amended answer setting up the alleged set-off against the cause of action set forth in the complaint.

The claim sought to be set off was not based on the determination and assessment of any deficiency.

The motion was opposed on the ground, among others, that the claim sought to be set up as a set-off was barred by the Statute of Limitations.

An order was entered denying the motion; **no appeal was taken from that order.**

Upon the trial appellant offered evidence in support of the set-off; objection was seasonably interposed. The court below permitted the evidence to be introduced "subject to objection".

The court below made findings of fact and conclusions of law in favor of the appellee on all of the issues, including the issue involved in the tendered set-off.

Appellant appealed from the judgment entered thereon and now seeks a review of the order denying the motion to interpose the set-off.

Appellee contends that this court is without jurisdiction to review the said order because it was appealable. No appeal was taken therefrom, and the time for an appeal expired prior to the taking of the appeal from the judgment. The notice of appeal does not refer to said order.

Assuming without admitting that the assignment of errors was sufficient for that purpose, appellee contends that the only reviewable questions are,

- (a) Was appellee authorized to adopt the accrual method of accounting?
- (b) Did the method employed "clearly reflect the income"?
- (c) Was the method adopted by the Commissioner authorized by the Internal Revenue Act and Regulations?

Findings of Fact and Conclusions of Law are set forth in full at pages 19 to 39 of the Transcript of Record.

The pertinent Statutes and Regulations are set forth at pages 101 to 107 of Appendix.

I.

RE: ASSIGNMENT OF ERROR THAT THE DISTRICT COURT ERRED IN ACCEPTING TAX-PAYER'S METHOD OF ACCOUNTING AND REJECTING COMMISSIONER'S

SUMMARY

a.

The assignment of error is insufficient to present any issue for consideration by the court, in that it does not set out "separately and particularly each error intended to be urged" and it does not state "as particularly as may be wherein the findings of fact and conclusions of law are alleged to be erroneous" (Rule 20 (d) of this court).

b.

The question of the proper method of accounting is one of fact. It is not the province of this court to try this case *de novo*. The findings of fact are presumptively correct and may not be set aside unless clearly erroneous. If the findings are sustained by substantial evidence they cannot be held to be clearly erroneous.

c.

All of the findings of fact, including the finding that appellee's method of accounting "clearly reflects the income", are supported by great preponderance of the evidence, and they sustain the conclusions of law. Indeed with a few inconsequential exceptions, appellee's evidence is uncontradicted.

d.

The Commissioner did not change any figure of annual "gross income" (Sec. 22), or annual "deductions" (Sec. 23). He only allocated (retrospectively) the accumulated three years total "net income" (Sec. 21) by arbitrarily allocating a percentage of the accumulated three year total of "net income" to each year, in violation of Sec. 21 of the Internal Revenue Code.

e.

If an error is made in reporting a particular item of "gross income" or "deduction" it does not authorize rejection of the accrual method of accounting; it only requires an adjustment of that particular item within the framework of the ac-

crual system. The Commissioner did not challenge any particular item. He only challenged the right to adopt the accrual method at all, and contends that the taxpayer should have adopted the "percentage of completion method".

U. S. v. American Can Co., 280 U.S. 412; 50 Sup. Ct. 177, 179.

Bartles Oil Co. v. Commissioner, 2 B.T.A. 16; Appendix p. 117.

Sneed v. Commissioner, 119 Fed. (2d) 767, 771 (5th Cir.); Appendix p. 118.

Merton's Law of Fed. Income Taxation, Vol. 1, page 493, Sec. 11.14; Appendix p. 119.

f.

The Internal Revenue Code and the regulations give to the taxpayer the absolute right to adopt any method of accounting which he deems suitable to his business, subject only to the condition that such method clearly reflect the income. A contractor engaged in the construction of buildings and structures which may extend over a period of more than one taxable year has the option to adopt (a) cash method, (b) accrual method, (c) percentage of completion method, or (d) completion of contract method. These are distinct methods. He has no right, and he cannot be compelled to adopt a "hybrid" method composed in part of each of the said four methods. The method adopted must be consistently maintained.

g.

A method of accounting that "clearly reflects the income" is one in which the books are "kept

fairly, honestly, straightforwardly and frankly," as distinct from "accurately or without error or defect". When so kept, the books are controlling, unless there has been an attempt of some sort to evade the tax.

Osterloh v. Lucas, 37 Fed. (2d) 277 (9th Cir.).

Huntington Securities Corp. v. Busey, 112 Fed. (2d) 368, 370 (6th Cir.), citing with approval the Osterloh case.

Welch v. DeBlois, 94 Fed. (2d) 842 (1st Cir.).

h.

The term "clearly reflect the income" does not refer to the income in any "given year". It refers to the total income "over a period of years growing out of and in some way related to an initial transaction in the taxable year."

Security Flour Mills Co. v. Commissioner, 321 U.S. 281; 64 Sup. Ct. 596, 599.

i.

If the taxpayer's method of accounting clearly reflects the income, the statute is "mandatory" on both the taxpayer and the Commissioner that taxable income must be determined in accordance therewith.

Huntington Securities Corp. v. Busey, 112 Fed. (2d) 368, 370 (6th Cir.).

Rowe v. Commissioner, 7 B.T.A. 903-908.

Coatesville Boiler Works v. Commissioner, 9 B.T.A. 1242.

Index Notion Co. v. Commissioner, 3 B.T.A. 90.

j.

A taxpayer who is engaged in the performance of long-term contracts is not compelled to adopt the "percentage of completion" method of accounting. He may do so at his option.

Regulation 111, Sec. 29.42-4, p. 260; Appendix p. 105.

Orino v. Commissioner, 34 B.T.A. 726.

k.

Appellee, who maintained his accounts on the accrual method, was not required to carry any record of inventories, prepaid expense or work in progress because (a) the Internal Revenue Code and regulations do not require such records, and (b) the findings of fact supported by substantial evidence established that appellee did not have any stocks of merchandise or materials on hand or work in progress to be recorded in such records.

l.

The method of accounting employed by the Commissioner in determining the deficiency was a hybrid, illegal and concededly "retrospective" method of accounting, and it is admitted (Brief, p. 17) that it is not "explicitly provided for by the Regulations nor by the Internal Revenue Code". The determination of a deficiency and the assessment based thereon were therefore illegal.

ARGUMENT

Statement of Facts Pertaining to Accounting Method.

Appellee's income was derived from public works contracts entered into with government agencies for the construction of buildings and other public works. The contracts were, generally speaking, of three types: (a) lump sum contracts; (b) cost plus percentage contracts; (c) cost plus fixed fee contracts and one contract in which the government agency agreed to pay a fixed amount per cubic yard of cement work to cover all costs for all materials, labor and supervision supplied.

All contracts made provision for periodic (monthly) payments on "estimates" approved by the engineer or other official designated in the contract for that purpose.

All contracts made provision for retention of a fixed percentage of the amounts determined by the estimates to insure faithful performance of the contracts.

There was some variation (not material) in the terms of the retained percentage provisions. In the main they provided for retention of a fixed percentage of the determined amount of labor and material **incorporated** into the structure and a different fixed percentage of the amount of the **materials not incorporated** into the structure.

Monthly "estimates" were made as follows: The superintendent in charge of a particular job would figure up how much appellee was entitled to receive. The figures were then submitted informally to the engineer or architect in charge and were gone over with him. When they reached an agreement a formal statement was prepared and submitted, upon which the official in charge issued the requisite certificate. Appellee's bookkeepers then prepared an invoice for the total amount found to be due to the appellee. The invoice together with supporting documents and certificate were forwarded to the proper channels for payment (Tr. 155 to 157, 233).

The invoices were issued for 100% of the amounts found to be due, without deduction for the retained percentages. These deductions were taken when payment was made.

When the invoices were issued, the amount thereof was entered on the books of the appellee in two accounts; one account recorded the amount that was **presently payable** and the other recorded the amount of the retained percentages, payment of which was deferred until completion as an "account receivable" (Tr. 279, 287, 288).

In making up the monthly "estimates" and invoicing, it was the policy to include as much of the labor and material as could possibly be legally included, so that the maximum payments could be obtained (Tr. 162, 176, 233). This was the prac-

tice that was uniformly followed (Tr. 162).

In one or two instances controversies arose between the appellee and the officer in charge, as to whether a certain piece of work had been completed in accordance with the contract. In those instances the officer refused to issue the requisite certificate and appellee was unable to render any invoice for payment, and hence did not enter on his books the amount that was deemed to be owing until the controversy was terminated and appellee became entitled to the issuance of an engineer's certificate (Tr. 168). The "estimate" would then be submitted, certificate obtained, invoice issued, and the amount would then be accrued on the books.

The Milwaukie Housing Project, Job No. 207 (Revenue Agent's report, Exhibit "20", Tr. 612, first line) is an illustration. The contract had been fully completed in 1942 according to appellee's version and he would have been entitled to receive approval of the payment of \$7634.09. The engineer, however, questioned the compliance with the contract and refused to issue the certificate in 1942 until certain corrections were made. These corrections were made in 1943, at a cost of \$575.12, whereupon the engineer approved the work and issued the certificate, which enabled the contractor to render an invoice for the sum of \$7634.09, and at that time accrued that amount on the books as income. The cost of that project (except \$575.12 expended in 1943) was accrued in 1942 when the expense was incurred. The \$575.12 was accrued as

an expense in 1943. The \$7634.09 could not be accrued as income in 1942 because without the engineer's certificate, appellee did not have the "right to receive" that sum under the contract. The government did not become liable until 1943 when the certificate was issued and an invoice could be rendered (Tr. 168, 169). All of the billing or invoicing was made and the amounts accrued on the books on the "estimates" approved by the engineers in charge (Tr. 203, 204, 205, 233).

All expense was accrued at the time it was incurred and the "obligation to pay" the same became fixed. The income was accrued when the "right to receive" payment became fixed by the issuance of the engineer's certificate (Tr. 247, 249, 278).

The books of account were kept on the accrual basis (Tr. 272). There was set up on the books all of the accounts usual and necessary to an accrual system of bookkeeping (Tr. 275, 276, 393). They were (Tr. 343), "accounts payable," "accounts receivable," "accrued expense," "accrued Federal Social Security," "accrued unemployment compensation," "accrued interest payable," "accrued payroll," "accrued taxes," "notes payable," "bonuses payable," "and other accounts of this type."

The returns were made from the books as so kept (Tr. 277, 278). When an "estimate" was not approved no billing could be made and the amount was not entered in the books (Tr. 315). Materials

that were on hand and not yet incorporated were included in the "estimates" (Tr. 340).

Mr. Garthe Brown, an accountant, testified that he had examined the books of account; that the books were kept on a true accrual basis (Tr. 349); that they clearly reflect the "income" (Tr. 351); that under the accrual method as applied to a contractor no inventory account or work in progress account was necessary (Tr. 353, 380); that the accounts were kept according to good accounting practice (Tr. 354, 381); that under Mr. Williams' (Revenue Agent) method of accounting a taxpayer could never make a return at the end of a tax year, but would have to wait until the end of the completion of the contract and go back three years and recompute the profits (Tr. 381).

Mr. Frank Eiseman, a certified public accountant, testified that he had examined the books of account of appellee; that the method employed was consistently followed during the years 1939 to 1944; that the method employed was an accrual method (Tr. 392, 393), and that the books contained all of the accounts appropriate to an accrual method.

He examined the income tax returns and found that they were made in accordance with the accounts as they were kept (Tr. 393). He found that the books "clearly reflect the income" within the meaning of the Internal Revenue Code and Regulations (Tr. 394). He found that all billings were

based on the engineer's "estimate" attached to the billings (Tr. 396); the profits were reflected on the books on the strict accrual method of accounting (Tr. 396). On a percentage of completion basis inventories have to be taken into account, but on the accrual method for construction contracts the Commissioner does not require any inventories (Tr. 403). On the accrual method of accounting applied to a contractor it is unnecessary to take into account stock piles on hand and uncompleted work at the end of the year because the accrual method is based "on the right to receive a certain amount and the obligation to pay" (Tr. 422). It was proper accounting to accrue the retained percentages as income, and the retained percentages were actually included in the income (Tr. 422).

W. G. Williams, the revenue agent who made the report, Exhibit "20" (Tr. 593 to 619) and which appellant concedes is the basis of the deficiency assessment (Tr. p. 4), testified on direct examination that from 1938 through 1944 the account books were kept on the accrual basis; that liabilities were entered on the accrual basis and the income was entered on the billed basis (Tr. 439).

"When the taxpayer billed the owner for the amount of construction completed and for the amount of materials and supplies in stock piles, he billed for 100% of the contract price attributed to the construction and for 75% of the contract price—75% of the cost of materials in stock piles." (Tr. 443)

He illustrated the procedure by assuming a billing of \$200,000 for construction work and a billing of \$100,000 for materials in stock piles, and pointed out that on such billing appellee would be paid 90% of the billing for construction work (10% being retained), and he would be paid 75% of the materials (25% being retained) (Tr. 445).

In making the examination he saw "no attempt to fraudulently evade taxes" (Tr. 461). He testified that when he used the term "inventory" he used the word "loosely" as referring to work in progress (Tr. 464). **Under the system used by appellee all inventory of work in progress was "taken into account" up to the time that they were billed on the "estimates" approved by the engineers (Tr. 465).** He conceded that the retained percentage was set up on the books and accrued to profit and loss in the taxpayer's books (Tr. 466). If there was no work in progress that was not included in the estimate, there would be no need for setting up any account for that purpose (Tr. 467). The same is true if there were no materials on hand which were not included in the estimates. There would be no need for maintaining an account for that purpose (Tr. 462). **He did not know whether there was in fact any inventory or work in progress that had not been included in the approved estimates and billings (Tr. 468).** The same system of accounting was consistently maintained from 1939 to 1944 (Tr. 471). The accounts were on the accrual basis. The income and the liabilities were

accrued on the books as of the end of the year (Tr. 471).

Mr. Williams testified that in making his computation he did not adopt the "percentage of **completion** method" but applied a "percentage of **profit** method" and that the two are not the same thing (Tr. 478). **He did not change the income that was reported in each year (Tr. 479). For the purpose of his computation he took the total profits for the three years, which was ascertainable only upon completion of all the work (Tr. 482), and divided that by the total of all costs for the three years (Tr. 482) to arrive at the percentage of profit to be applied to each year (Tr. 483). Without waiting for the full three years to expire he could not have arrived at that formula accurately (Tr. 483). He admitted that he applied in part a percentage of completion basis or percentage of income basis to the appellee's accrual method of accounting (Tr. 484). He did not apply the completed contract method.**

He was asked which of the four optional methods authorized by the Internal Revenue Code and Regulations he applied, whether it was cash, accrual, percentage of completion or completed contract basis, and he replied, "I used strictly neither one." (Tr. 486) He admitted that he ignored the methods authorized by the Act (Tr. 486, 487). He admitted (Tr. 490) that the retained percentage "was charged on the books and credited to profit and loss at the end of the year, and \$200,000, the

assumed amount of billing, was properly accrued on the books.”

With respect to materials, he had assumed that the books had only accrued the portion to be paid on the “estimates” and that the retained percentage of 25% “which was not accrued has been left dangling in the air. That is my recollection as to how the matter happened,” and that the 25% retained percentage had not been accrued (Tr. 491). But upon examination of the books in court, Mr. Williams testified (Tr. 513), “**I found the 25% retention to have been properly accrued on the books.**” Thus he finally testified that all of the construction work had been properly accrued as to the amount presently payable as well as the retained percentage, and that as to the materials not incorporated the retained percentage as well as the amount presently due was properly accrued.

1.

Re: Sufficiency of Assignment of Error

We submit that the Assignment of Error No. I is insufficient to present any issue for consideration because it fails to supply the particularity required by **Rule 20 (d)** of this court. Appellant fails to state “wherein the findings of fact and conclusions of law are alleged to be erroneous”. The question of the appropriate method of accounting involves a number of questions which were dealt with in the findings of fact. They are:

(a) whether the method employed was a true accounting method; (b) whether the taxpayer had the right to employ that method; (c) whether the accounts as kept clearly reflect the income within the meaning of the Internal Revenue Code, and (d) whether inventory and work in progress accounts had to be maintained.

No particular issue is referred to. The court is called upon to retry the case.

In **American Surety Co. vs. Fischer Warehouse Co.**, 88 Fed. (2d) 536, 539 (9th Cir.), this court held that it was not sufficient to assert generally that the court made wrong findings and thereby

“invite this court to retry the case without indicating in what respects or for what reasons the findings are erroneous.”

2.

Re: Scope of Review.

The court below made findings of fact that appellee was authorized to adopt the accrual method of accounting; that he did adopt that method of accounting; that he followed it consistently throughout all the years, including the tax years in question; that the accounts were honestly, fairly, straightforwardly and frankly maintained; that the accounts clearly reflected the income and that they were not maintained or carried on with any purpose of evading or minimizing tax liability (Tr. 27).

It is now well settled that upon review in this court these findings of fact are presumptively correct, that they will not be set aside unless clearly erroneous and that a finding is not clearly erroneous if it is supported by substantial evidence. The case is not here for trial *de novo*. The burden is upon the appellant to demonstrate that the findings are clearly erroneous.

Rule 52a, Federal Rules of Civil Procedure.
Augustine v. Bowles, 149 Fed. (2d) 93 (9th Cir.).

Lerner Stores Corp. v. Lerner, 162 Fed. (2d) 160 (9th Cir.).

Hartford Accident & Indemnity Co. v. Jasper, 144 Fed. (2d) 266 (9th Cir.).

Occidental Life Insurance Co. v. Thomas, 107 Fed. (2d) 876 (9th Cir.).

Goldstein v. Polakof, 135 Fed. (2d) 45 (9th Cir.).

In Commissioner of Internal Revenue v. Scottish Amer. Inv. Co., 323 U.S. 119; 65 Sup. Ct. 169, the court said:

“The judicial eye must not in the first instance rove about searching for evidence to support other conflicting inferences and conclusions which the judges or the litigants may consider more reasonable or desirable. It must be cast directly and primarily upon the evidence in support of those made by the Tax Court.”

3.

The Finding of Fact That Appellee Was Authorized to Adopt the Accrual Method of Accounting Is Supported by the Commissioner's Letter in Evidence.

The commissioner rejected appellee's accrual method of accounting on the assumption that appellee had not obtained permission to adopt that method. The court below found that appellee did obtain permission. Appellant asserts that the court below erred in so holding.

Prior to January 1, 1948, the contracting business was carried on by a corporation of which appellee was the owner of all of the stock. The corporation was dissolved as of December 31, 1937, and the business was thereafter continued by appellee individually until the partnership with his son was formed in 1942. At the time of the dissolution of the corporation, appellee was **individually** reporting income on the cash basis. He desired to change his individual method of accounting and reporting income from the cash to the accrual method.

To that end on March 3, 1938 he applied to the commissioner (Def. Ex. 28, Tr. 633) for permission to do so. In the first paragraph of the letter he asks that the corporation be permitted to report upon the percentage of completion basis. This had reference to the uncompleted contracts of the corporation at the time of the dissolution.

In the concluding paragraph of the letter he says:

“In view of the fact that the corporation’s books have been kept on the **accrual** basis, the individual books would be kept on a similar basis and the returns made accordingly on the **accrual** basis.”

In the letter of April 5, 1938 (Tr. 636) appellee, in response to an inquiry from the commissioner, wrote:

“The corporation has been dissolved, and all future returns will be made as an individual, and, since the main income of Ross B. Hammond is from the construction business which has been kept on an **accrual** basis, we therefore, request definite permission to make all future returns of Ross B. Hammond as an individual on the same basis as the corporation had previously made returns, which is the **accrual** basis.”

In the letter of May 9, 1938 (Tr. 639) appellee furnished certain information requested by the commissioner and states (Tr. 640):

“As previously stated, the reason for seeking permission to file on the **accrual** basis is occasioned by the fact that I have personally taken over the contracting business previously conducted by Ross B. Hammond, Inc., and, as you have been advised heretofore, the accounts of that company were kept on the accrual basis. Request has therefore been made for permission to report my income from the contracting business upon the **accrual** basis, and it is desired that the return be uniform with respect to my personal income.”

On July 7, 1938 the commissioner wrote (Pl. Ex. 1, Tr. 518):

“Predicated on the foregoing, permission is hereby granted you to change your method of reporting income **from the cash to the accrual basis**, beginning with the taxable year ending December 31, 1938.

“A copy of this letter should be attached to your return for the taxable year ending December 31, 1938, as evidence of the authority given you to report your net income on the accrual basis for Federal income tax purposes.”

There is some confusion (immaterial here) as to whether the corporation was on the percentage of completion or accrual basis. But there is no question at all that the **appellee individually** had been on the cash basis and that he desired to change to the accrual basis after the dissolution of the corporation. He individually was seeking the change, not the corporation. He reiterates in all his letters his desire to adopt the accrual method, and the concluding letter from the commissioner grants that request without any qualification or condition.

Appellant asserts (Br. p. 13) that:

“Taxpayer actually received permission to use an accrual basis coupled with permission to report long-term contracts on a percentage of completion basis.”

The commissioner’s concluding letter, dated July 7, 1938 (Tr. 518) did not couple the two methods. The letter authorizes the adoption of the

accrual method without condition.

The Commissioner thereafter construed that letter as permission to report all of appellee's operations on the accrual method because, beginning with January 1, 1939, down to and including the tax years in question, appellee adopted the accrual method of accounting and reported his income in each of said years on that basis. The income tax returns so recite. Each of said returns was **twice examined and audited** and reports rendered thereon, and in no instance except in the present tax year in question did the Commissioner challenge the right of the appellee to adopt and use the accrual method of accounting and to make his returns on that basis.

It is a proper presumption that the Commissioner did not challenge the right to adopt the accrual method in recognition of the permission granted by the letter of July 7, 1938 (Ex. "1", Tr. 518).

Even if the formal permission to adopt the accrual method had not been issued by the Commissioner, the long acceptance of the returns on the accrual method would constitute an implied permission which would preclude the right of the Commissioner to reject the method in the tax years now involved.

In **Fowler Bros. & Cox v. Commissioner**, 138 Fed. (2d) 774 (6th Cir.), the taxpayer changed his method of accounting without receiving permission

from the Commissioner, and thereafter reported his income for several years on the changed method. The court held:

“* * * Such requirement (referring to permission) may be satisfied by the Commissioner’s acceptance of returns which give notice to him that the method originally adopted has been changed; and the situation then stands as though the Commissioner had given express permission to allow the change in method of accounting.”

Since it is established that the appellee did have the right to adopt the accrual method of accounting, appellant’s contention that he had the right to reject that method of accounting and substitute another, insofar as it is based upon lack of authority, must be rejected.

4.

The Finding of Fact that Appellee’s Method of Accounting “Clearly Reflected the Income” Is Sustained by Substantial Evidence.

It is established beyond question that if the method of accounting “clearly reflects the income” the right of the taxpayer to choose the method of accounting is “mandatory” and the Commissioner has no right to substitute another method.

Sec. 41, Int. Rev. Code; Appendix p. 102.
Regulation 111, Sec. 29.41-1; Appendix p. 102.
Huntington Sec. Corp. v. Busey, 112 Fed.
(2d) 368, 370 (6th Cir.).
Rowe v. Commissioner, 7 B.T.A. 903-908.

Coatesville Boiler Works v. Commissioner,
9 B.T.A. 1242.

Index Notion Co. v. Commissioner, 3 B.T.A.
90.

Appellee could not be compelled to adopt any particular method of accounting. He has the option to choose such method “as in his judgment best suited to his purpose”, subject only to the condition that it “clearly reflect the income”. Appellee was not compelled to adopt the “percentage of completion” method of accounting.

Regulation 111, Sec. 29.42-4, p. 260; Appendix p. 105.

Orino v. Commissioner, 34 B.T.A. 726.

Security Flour Mills Co. v. Commissioner,
321 U.S. 281; 64 Sup. Ct. 596; Appendix
p. 112.

Regulation 111, Sec. 29.42-4 (Appendix p. 105) defines long-term contracts and provides in subdivision (a) that gross income derived from such contracts “may” be reported upon the basis of percentage of completion. This provision merely makes it optional with the taxpayer. (**Orino v. Commissioner, supra.**) He cannot be compelled to adopt that method. Only when he does adopt it are the regulations pertaining to that particular method applicable.

The phrase “clearly reflect the income” is not defined by the Revenue Act or the Regulations.

Note that the phrase does not use the statutory words “gross income,” or “net income”. It merely

uses the word "income". Regulation 111, 29.21-1 (a), says:

"Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital."

This court and others have decided that a method of accounting "clearly reflects the income" when the books are kept "fairly," "honestly," "straightforwardly" and "frankly," as distinct from "accurately" or "without error or defect". The phrase refers to the **system** or **method** and not to any error in bookkeeping, which may be corrected by adjustment. It is established that when the books are so kept they are controlling unless there has been an attempt of some sort "to evade the tax".

In **Osterloh v. Lucas**, 37 F. (2d) 277 (9th Cir.), the court held:

"The method of accounting regularly employed by the petitioner is a recognized one within the meaning of the act, and should be accepted as controlling unless such method does not clearly reflect the income.

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"The case turns largely upon what is meant by the requirement that the method of accounting shall clearly reflect the income. If this requirement is absolute, it is safe to say that books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income, because nearly always at the end of a tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid. But we do not think that any such literal construction was

contemplated. In our opinion, all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax. This construction may work to the disadvantage of the taxpayer or the government at times, but if followed out consistently and honestly year after year the result in the end will approximate equality as nearly as we can hope for in the administration of a revenue law." (Emphasis supplied)

In **Welch v. De Blois**, 94 Fed. (2d) 842 (1st Cir.), the court after quoting in full the last paragraph of the excerpt from the **Osterloh** case said:

"With this statement we fully agree."

In **Huntington Securities Corporation v. Busey**, 112 F. (2d) 368-370 (6th Cir.), the court held, citing the **Osterloh** case:

"If the taxpayer's method of accounting clearly reflects income, the Statute is mandatory on both him and the Commissioner that taxable income must be determined in accordance therewith. The selection of a system of accounting is lodged exclusively in the taxpayer provided it is within the statutory limits of clearly reflecting income and whatever method the taxpayer adopts must be consistent from year to year unless the Commissioner authorizes a change.

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"**'Method,'** as used in the present statute, means the way of keeping the taxpayer's books according to a defined and regular plan. **'Clearly,'** as used in the statute, means plainly,

honestly, straightforwardly and frankly, but does not means ‘**accurately**’ which, in its ordinary use, means precisely, exactly, correctly, without error or defect.

“The method used by appellant in valuing its inventories in our opinion clearly, but not accurately, reflected income, which is all that is required. *Osterloh v. Lucas*, 9 Cir., 37 F. 2d 277. Appellant’s books of account accurately showed the cost of the securities from year to year and the differences between actual and book cost were unsubstantial. They were approximately correct on a cost basis. The errors appearing therein were easily ascertainable and correctible from the books of account which were kept plainly, honestly and straightforwardly. In our opinion, the errors of the taxpayer did not bring into operation the wide discretion of the Commissioner to reject its method of valuing inventories which was approximately correct and to select one which was at variance with the taxpayer’s consistent method.” (Emphasis supplied)

In *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281; 64 Sup. Ct. 596; Appendix p. 112, the Supreme Court held that the phrase “clearly reflect the income” did not refer to the income in any “given year” but refers to the total income

“over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year.”

Regulation 111, Sec. 29.41-2, p. 253, says:

“Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.”

Regulation 111, Sec. 29.41-3, p. 255, says:

“The law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose.”

Aside from the bare assertion that appellee's method does not clearly reflect the income and that the income is “distorted”, there is not the slightest attempt made to demonstrate that the findings of fact in this respect are “clearly erroneous”.

Appellee, having adopted the accrual method of accounting, treated as “gross income” all the invoices rendered based on “monthly estimates” approved by the government engineers as of the time the invoices were rendered, regardless of the time they were paid. They were accrued on the books as income in the month and year the invoices were rendered. This applied to the amounts **presently due** and the **retained percentages**. When the invoices were rendered, the “right to receive” payment accrued. The costs for labor, materials, etc. were entered upon the books as of the time in the month and year they were incurred, regardless of when paid. When the “obligation to pay” arose they were accrued on the books as “deductions”.

It is now settled beyond question that the “right to receive” and the “obligation to pay” create the right and duty to accrue “gross income” and “deductions”. It is mandatory that both “gross income” and “deductions” must be taken in the years in which the events occurred that give rise to the

“right to receive” and the “obligation to pay”.

In **Am. Potash & Chemical Corp. v. Commissioner**, 7 T.C. 1113, the court held:

“Where the accrual method of accounting is used items of income and expense must be allocated to the years in which the **right to receive** or the **obligation to pay** has become final and definite in amount.”

Helvering v. Enright's Est., 312 U.S. 636; 61 Sup. Ct. 777; Appendix p. 115.

Spring City Fdry. v. Commissioner, 292 U.S. 182; 54 Sup. Ct. 644; Appendix p. 115.

Security Flouring Mills Co. v. Commissioner, 321 U.S. 281; 64 Sup. Ct. 596; Appendix p. 112.

Frost Lumber Industries v. Commissioner, 128 Fed. (2d) 693, 694 (5th Cir.); Appendix p. 115.

Pfeiffer v. Jones, 57 Fed. Supp. 621; Appendix p. 116.

U. S. v. Detroit Moulding Corp., 56 Fed. Supp. 754, 757; Appendix p. 117.

U. S. v. Anderson, 269 U.S. 422; 46 Sup. Ct. 131; Appendix p. 125.

Willoughby Camera Stores v. Commissioner, 125 Fed. (2d) 607 (2d Cir.); Appendix p. 120.

Helvering v. Russian Finance & Constr. Corp., 77 Fed. (2d) 324 (2d Cir.); Appendix p. 123.

Appellant points to the fact that the “net income” in some instances seems to be large and in some instances small in comparison to the “gross income”, but that in itself is irrelevant. Some transactions may produce large profits, others small profits, and still others losses, depending

upon an infinite variety of conditions.

For example, in one instance, appellee obtained payment of a very large sum without any expenditure, due to the fact that another corporation performed a large amount of earth filling that appellee was required to do under his contract with the government agency (Tr. 165, 166).

Then there are conditions inherent in all accounting systems resulting from the fact that at the end of a given year there is usually some "unfinished business", that is (whether on the cash or accrual basis) receipts and disbursements do not coincide in the same year.

Regulation 111, 29.43-2, p. 266, recognizes this condition and therefore provides:

"It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts."

In this case all accruals both "gross income and deductions" were made monthly including the month of December in each year (Tr. 275). Taxpayer did not wait until the end of the year to determine whether the accruals should be taken in that year or in the succeeding year, and that was done "pursuant to a consistent policy" over the years.

Taxpayers have no choice in the matter under any accounting system under the requirements for **annual** reporting, whether it be cash or accrual method. A contractor on the cash basis may have invoiced a hundred thousand dollars of work in one year but could not treat it as income in that year if not paid. On the other hand, if he is on the accrual basis and he has invoiced a hundred thousand dollars worth of work, he **must** treat that as income although no payment has been received. The same is true of expense.

These requirements are mandatory. Whatever effect these conditions have upon the determination of statutory "net income" is inherent in the requirement for annual accounting and reporting income.

This court took note of this situation in the **Osterloh case**, *supra*. The court there said:

"The case turns largely upon what is meant by the requirement that the method of accounting shall clearly reflect the income. If this requirement is absolute, it is safe to say that books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income because nearly always at the end of a tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid. But we do not think any such literal construction was contemplated."

The Supreme Court of the United States also took note of that condition in the **Security Flouring Mills Co. case**, *supra*.

Even if errors are found in the treatment of some entries of income or expense, it would not authorize the rejection of the taxpayer's method of accounting on the accrual basis. It would merely require **adjustment** of that item by allocation to the proper year. It would not authorize the rejection of the accounting method.

In United States v. American Can Co., 280 U.S. 412; 50 S. Ct. 177-180, the court held:

“ ‘Basis of keeping accounts’ as there used **refers to the general bookkeeping system followed by the taxpayer and not to the accuracy or propriety of mere individual items or entries upon the books. And to correct an improper item in a return—whether the result of mere error or designed—cannot properly be said to constitute rejection of the basis upon which the return was constructed.**”

Bartles-Scott Oil Co. v. Commissioner, 2 B.T.A. 16; Appendix p. 117.

Sneed v. Commissioner, 119 Fed. (2d) 767-771 (5th Cir.); Appendix p. 118.

Merten's Law of Fed. Income Taxation, Vol. 1, Sec. 11.14, p. 493; Appendix p. 119.

We submit that appellee's method of accounting “clearly reflected the income” as that term is interpreted in the foregoing decisions, which precluded the Commissioner from rejecting that method and substituting another.

Appellee adopted the accrual method of accounting and consistently maintained the same to and including the tax years in question. The two accountants, Brown and Eisman, who testified for

the plaintiff, as well as appellee's own bookkeeper, testified that the accounts were kept on the accrual basis; that the books set up all of the separate accounts that are usual to such method of accounting, such as accounts receivable, accounts payable, accrued taxes, accrued interest, accrued salaries, and so forth, and that the method so employed "clearly reflected the income".

Mr. Williams admitted that he found no evidence of any attempt to evade taxation by means of the method employed by appellee (Tr. 481).

The accrual method of accounting is, of course, a standard, recognized method, and under the **Regulation 111, Sec. 29.41-2**, Appendix p. 103, it "will ordinarily be regarded as clearly reflecting income".

It is clear from the record that the accounts were fairly, honestly, straightforwardly and frankly kept and maintained. There is not the slightest intimation in the revenue agent's report or in his testimony of any omission from gross income or any unwarranted addition to the deductions. The method of accounting therefore clearly reflects the income within the tests laid down in the **Osterloh case** and the others cited above.

The best evidence that the method of accounting clearly reflects the income is to be found in the fact that the Commissioner did not change a single figure relating to the **annual** "gross income" from each contract, or the **annual** "deductions" pertain-

ing to each contract, or the **total** net profit realized from each contract upon completion thereof. The Commissioner, in fact, adopted all of these figures.

The Commissioner did not reallocate any item of "gross income" or "deduction" pertaining to any contract in any of the three years that he examined.

Section 21 of the Internal Revenue Act defines "net income" as

"the gross income computed under Section 22, less the deductions allowed by Section 23."

This is the mandatory formula for computing "net income".

Since the Commissioner did not question any of the items of "gross income" or "deduction" as reported by appellee in any of the years in question, it follows that the "net income" reported by appellee (the difference between the said "gross income" and the said "deductions") is the proper "net income to be reported".

The Commissioner accepted the items of gross income and deductions as reported, but refused to accept the net result that follows therefrom, and insists on substituting a method of determining "net profit" in violation of **Sec. 21 of the Internal Revenue Act**.

Instead of treating the difference between "gross income" and the "deductions" as the "net income", as required by **Sec. 21**, he resorted to a

formula of his own which he concedes finds no authority in the Internal Revenue Code or Regulations for determining the net income for each year. He allocated to each year only a percentage of the total net profits **ascertained upon the completion** of the contracts at the **end of three years**. The taxpayer and Commissioner are both compelled to follow the **Section 21** formula for computing "net income".

In **Clifton Mfg. Co. v. Commissioner**, 137 Fed. (2d) 290 (4th Cir.), referring to the provision which authorizes the Commissioner to adopt another method of accounting if the taxpayer's method does not clearly reflect the income, the court said:

"But, it can hardly be said that this authority empowers the Commissioner to add to the taxpayer's gross income for a given year an item which rightfully belongs to an earlier year under the recognized system of accrual accounting."

With greater reason it must be said that that provision does not authorize him to compute "net income" by a method other than that provided for in Sec. 21. The subtraction of the "deductions" computed under Sec. 23 from "gross income", as computed under Sec. 22, to arrive at the annual "net income", clearly reflects the income as a matter of law.

The method of applying a percentage of profit ascertained from a **three years' total** of net profits,

without any change in the "gross income" and "deductions", does not comply with the statute and cannot be said to clearly reflect the income. It is inconsistent with the requirements for "accrual" reporting of income.

The result of this illegal reallocation of "net income" and the recomputation of the tax based thereon was as follows:

Tax Year	Net Income per Taxpayer	Net Income per Commissioner	Tax Paid	Tax Computed by Commissioner
1941	\$ 31,270.33	\$ 10,821.94	\$ 6,663.03	--
1942	195,680.63	370,889.23	95,991.87	\$251,994.19
1943	211,306.11	127,322.61	91,307.14	49,448.91

The following tabulations show the manner in which the tax was computed by the taxpayer and as recomputed by the Commissioner:

COMBINED INCOME TAX FOR 1942-1943 AS
COMPUTED BY APPELLEE AS PER CONSOLI-
DATED RETURN FOR 1943, PLAINTIFF'S
EXHIBIT 6.

Tax for **1942** on "net income" as reported by appellee in the combined 1942-1943 return was the sum of \$95,991.87

The tax for **1943** on "net income" as reported by appellee in the combined 1942 and 1943 return was 91,307.14

Since the 1943 tax so reported was the lesser, appellee was entitled to de-

duct 75% of the amount of that tax	68,480.36	
Leaving as the amount of tax to be paid for that year (1943)		\$22,826.78
Adding the amount of the 1942 tax computed as above		95,991.87
		<hr/>
The total of the combined 1942-1943 tax reported and paid was		\$118,818.65

COMBINED TAX FOR 1942 AND 1943 COM-
PUTED ON "NET INCOME" AS REALLOCATED
BY THE COMMISSIONER (REVENUE AGENT'S
REPORT, PLAINTIFF'S EXHIBIT 20).

Tax for the year 1942 based on the reallocation (p. 9, Plaintiff's Exhibit 20)	\$251,994.19	
Tax for the year 1943 based on the reallocation (p. 14, Plaintiff's Exhibit 20)	49,448.91	
Since 1943 tax was the lesser, appellee was entitled to deduct 75% of the amount so computed	37,086.68	
	<hr/>	
Leaving the amount of the tax to be paid for that year (1943)		\$ 12,362.23
Adding the amount of the 1942 tax computed as above		251.994.19
		<hr/>
Total of combined 1942- 1943 tax based on realloca- tion		\$264,356.42

RECAPITULATION

Amount of tax based on reallocation of "net income"	\$264,356.42
Amount of tax computed and paid on appelle's basis	118,818.65
Deficiency determined	<u>\$145,537.77</u>
Interest to date of payment by appellee	11,609.13
Total payment	<u>\$157,146.90</u>
Amount paid in cash August 17, 1945	\$150,592.87
Credit allowed for refund on account of overassessment for the year 1941 plus accrued interest	6,554.03
Total	<u>\$157,146.90</u>
(See Plaintiff's Exhibit 9, "Certificate of assess- ment and payment," last page.)	

We invite the attention of the court to the manner in which the first contract (Job 207) appearing in the revenue agent's report (Exh. 20, Tr. 612) was treated. It is typical of the rest of the contracts and will be sufficient to illustrate the precise issue between the taxpayer and the Commissioner. The first line shows the "gross income" from that job entered on the accrual basis (as per approved estimates and invoices) for each of the years 1941, 1942 and 1943, and the last column shows the total for the three years. The Commissioner did not change any of these figures. Williams testified:

"I have not changed the income, your Honor,
that they have reported in each year.

.

"I am using exactly the same income that the engineer has allowed to be billed." (Tr. 479)

The next line records the costs on that job, broken down as to labor and material, which were accrued in each of the years 1941, 1942 and 1943, as the costs were incurred. The last column shows the total for the three year period. These figures were not changed.

The next line shows the "net profits" as they were entered on the books of the appellee for each of the years, and the total at the end of the three year period. The figures of net profits were arrived at in accordance with the formula required by Sec. 21 of the Internal Revenue Code, to-wit: the subtraction of the "deductions" from the "gross income".

The Commissioner then adopts the **total** figure of net income (\$37,415.05) from the job **as ascertained at the end of the three year period** (total of the 1941, 1942 and 1943 net profits); he divided that into the total "gross income" for the three year period, to-wit: \$289,200.76, and determined that the net profit on the whole job upon its completion at the end of the three year period was 12.9+ % of the total gross income from that job. The then computed 12.9+ % of the gross income for each of the three years and treated that as the "net income" for each of the three years, instead of the net income which was arrived at by the appellee in accordance with the requirements of Sec-

tion 21 of the Internal Revenue Code. The result was a decrease of the net income in the years 1941 and 1943 and a large increase for the year 1942.

The same procedure was followed with respect to all the other contracts. We submit that the procedure followed by appellee to arrive at "net income" clearly reflects the income because it was arrived at in accordance with the requirements of Section 21, while the method employed by the Commissioner was **arbitrary, capricious and without any foundation** (conceded) **either in the Internal Revenue Code or Regulations, or in any recognized accounting system.**

The Commissioner employed a "hybrid" method. He employed in part the accrual method when he adopted the annual "gross income" and annual "deductions" as the basis for computation. (Arrived at by appellee on the accrual basis.)

He employed in part the "completed contract" method when he used the **total** gross income and deductions ascertained at the end of the three-year period.

He employed in part a "transactional" method when he used the "percentage of profit" formula.

In the **Security Flour Mills** case, *supra*, the Supreme Court of the United States condemned the use of a "hybrid" method of computing net income. In that case the taxpayer contended that

"Section 43 has altered the rule so that a **hybrid system, partly annual and partly transactional**, may, within administrative discretion, be substituted for that of annual accounting periods."

The court said:

"We think the position is not maintainable.

.

"We are of the opinion that the purpose of the language which Congress used was not to substitute, whenever in the discretion of an administrative officer or tribunal such a course would seem proper, a **divided and inconsistent method** of accounting not particularly to be denominated either a cash or an accrual system." (Emphasis supplied)

The distortion of net income that is produced by the Commissioner's method of accounting is demonstrated by the application of his system to some of the contracts. In Job No. 213 (Tr. 615) the Commissioner computed a net income for the year 1943 of \$35,448.48, and a net income in 1944 of \$3,421.79; total for the two years, \$38,870.27. The evidence established that the total profit realized from that contract was \$27,160.05 (Tr. 501 to 504).

Similar discrepancies are disclosed by applying Commissioner's formula to contracts 215, 216, 217 and 220.

We submit that a method of accounting that produces a net profit of \$38,000.00 before completion of the contract, and a total net profit of \$27,-

000.00 upon completion of the contract, demonstrates such distortion as to make the adoption of the method impossible.

The obvious difficulty of adopting the Commissioner's method of accounting is that a **taxpayer could never make a return at the end of any given taxable year** if he had uncompleted contracts. If he is on the accrual basis he must make his returns annually. To apply the Commissioner's "percentage of net profit" formula, the taxpayer would have to wait in all cases until completion, because then only would he be able to determine the ratio of profit to gross income.

Appellant does not cite any authority for the right to adopt the method which he employed in this case. He concedes (Brief p. 17) that the method

“* * * is not one explicitly provided for by the Regulations nor by the Internal Revenue Code.”

The case of **William Hardy v. Commissioner of Internal Revenue**, 82 Fed. (2d) 249, is cited in support of the contention that the Commissioner “was not required to adhere strictly to a stereotyped accrual form of accounting”. But this statement was made by the court in connection with the peculiar situation that existed in that case as indicated by the very next sentence which reads as follows:

“It is obvious that there must be some leeway in making the change from the cash basis in order that the income for the first taxable period under the changed method of reporting will be reflected accurately.”

In that case the controversy involved the **tax year in which the taxpayer made the change from the cash to the accrual method**, and because of the inconsistency in the two methods of accounting, it became necessary to make adjustments to compensate for the difference. In the case at bar the accounts were kept on the accrual basis and income was reported on the same basis. There was no changeover in the tax year in question from one system to another which would necessitate adjustments.

The **Hardy case** is also cited by appellant in support of the proposition that “in deciding what method is necessary clearly to reflect a taxpayer’s income, the commissioner is given a breadth of discretion which, though not unlimited, will be reviewed here only when abuse of it is clearly shown”.

The right accorded to the Commissioner by Section 41 of the Internal Revenue Act to substitute a method of accounting arises only when the method of accounting adopted by the taxpayer does not clearly reflect the income in the sense in which that language is employed in the Internal Revenue Act and as interpreted by the courts. If the taxpayer’s method does clearly reflect the income, as that term is so used and interpreted by the courts,

the Commissioner has no right whatever to substitute any other method of accounting.

When it is established that the taxpayer's method of accounting does not clearly reflect the income, the right of the Commissioner to adopt another method attaches; but the method which he employs must be one that is recognized by the Internal Revenue Code and must accord with recognized accounting principles. He can not even then employ a "hybrid" system "partly annual and partly transactional", or "a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system". **Security Flour Mills Co. case**, *supra*.

The value of the **Hardy case** as precedent is greatly impaired if not entirely dissipated by the decision of the Supreme Court in the **Security Flour Mills Co. case** in the respects just referred to.

What was said with respect to the **Hardy case** applies to the other cases cited by appellant at that point.

In **Bradstreet Co. of Maine v. Commissioner of Int. Rev.**, 65 Fed. (2d) 943 (1st Cir.), the court held:

"The burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the taxpayer."

In **re Harrington**, 1 F. (2d) 749 (D.C. Mo.), the court held:

“This is, of course, the fundamental purpose of the law that the taxpayer should be taxed upon his actual income, and that this should neither be diminished nor increased by any arbitrary or artificial method of computation. As the law says, ‘the true income must be clearly reflected,’ and for this purpose the regular and long-standing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged.”

In Russell v. Commissioner of Internal Revenue, 45 F. (2d) 100-101 (1st Cir.), the court held:

“An arbitrary adoption of a substitute method of computing a tax, which does not in fact ‘clearly reflect the income’ of the taxpayers, cannot be sustained. The commissioner’s discretion must be exercised reasonably, on sound grounds.”

In Carver vs. Commissioner of Internal Revenue, 10 T.C. 171, cited by appellant, the taxpayer maintained his accounts on the accrual basis but reported income on the cash basis. This was the situation upon which the tax court held that the return did not clearly reflect the income. This was a violation of the requirement that there must be consistency between the accounts and the return. The court held that **upon the record as made** the taxpayer failed to “demonstrate error on the part of the commissioner”. In the case at bar, the accounts were maintained on the accrual basis and the income was reported on the accrual basis.

There was no inconsistency. In the case at bar, unlike the situation in the **Carver case**, the court below upon the evidence found as a matter of fact that the taxpayer sustained the burden of establishing that the deficiency assessed was illegal.

It is, of course, true that the Commissioner had at the outset the benefit of the presumption of correctness. But it is now settled beyond question that the presumption is dissipated and disappears when the taxpayer has introduced evidence which negatives the presumption.

In **J. M. Perry & Co., Inc. v. Commissioner**, 120 Fed. (2d) 123 (9th Cir.), the court held:

“When such evidence has been adduced the issue depends wholly upon the evidence so adduced and the evidence to be adduced by the Commissioner. **The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof.**” (Emphasis supplied)

Hemphill Schools, Inc. v. Commissioner, 137 Fed. (2d) 961-964 (9th Cir.); Appendix p. 111.

Helvering v. Talbott's Est., 116 Fed. (2d) 160 (4th Cir.); Appendix p. 111.

Lunsford v. Commissioner, 62 Fed. (2d) 740 (6th Cir.); Appendix p. 111.

Clinton Cotton Mills, Inc. v. Commissioner, 78 Fed. (2d) 292 (4th Cir.); Appendix p. 112.

Russell v. Commissioner, 45 Fed. (2d) 100 (1st Cir.); Appendix p. 112.

Whitney v. Commissioner, 73 Fed. (2d) 589 (3d Cir.); Appendix p. 110.

Under these decisions, when the evidence was introduced by appellee that an accrual method of accounting was consistently maintained throughout the years, that the returns were made in accordance with the accounts as kept and maintained; that as kept they clearly reflected the income, and that there was no need for inventory accounts or work in progress accounts because there were no materials or such work in progress in fact to be entered in such accounts, the presumption of correctness was dissipated and the burden of proof shifted to the government to establish that the method of accounting did not clearly reflect the income as the term is understood in the administration of the internal revenue law. The Commissioner made no attempt to meet that burden, and certainly did not introduce evidence creating a preponderance of evidence in his favor. The court below accepted that evidence and based its findings of fact thereon.

In this court, on appeal, as already pointed out, those findings of fact are presumptively correct and the burden is upon the appellant to demonstrate that those findings were clearly erroneous. We find not the slightest attempt in the Brief to make such demonstration.

Appellee and his witnesses were not impeached; their testimony was not contradicted by other testimony or by destructive analysis. The court below therefore was compelled to give credence to the evidence and to make findings of fact in ac-

cordance therewith.

Blackmer v. Commissioner, 70 Fed. (2d) 255 (2d Cir.).

Lawton v. Commissioner, 164 Fed. (2d) 380, 384 (6th Cir.).

In **Wright-Bernet, Inc. v. Commissioner, 172 Fed. (2d) 343 (6th Cir.) 1949**, the court reversed the decision of the Tax Court because it failed to accept and give effect to uncontradicted evidence of unimpeached witnesses.

5.

Re: Necessity of Maintaining an Inventory and Work in Progress Account

The only criticism of appellee's accrual method of accounting is based on the contention that appellee did not maintain an inventory and work-in-progress account.

This contention is predicated on the assumed applicability of **Treasury Regulation 111, Sec. 42-4 (a)** (Appendix p. 105).

We submit that this regulation does not apply to a contractor taxpayer reporting on the accrual method of accounting. It applies only to a contractor taxpayer who has elected to report on the **percentage of completion basis**. The Regulation says that contractors "may" report upon the percentage of completion basis; it does not say that he must. But it is only when the contractor elects

to adopt the percentage of completion method that he is required to supply the Commissioner with certificates of architects or engineers showing the percentage of completion, and the Regulation specifies what deductions from gross income are to be taken,

“account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in connection with the work under contract but not yet so applied.”

This Regulation does not refer at all to work in progress.

No such requirement is included in the Regulations governing the reporting on the accrual method of accounting.

Regulation 111, Sec. 29.41-3, Appendix p. 104, says:

“The law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suit to his purpose”

and in paragraph (1) it goes on to say:

“In all cases in which the production, purchase, or sale of merchandise of any kind is an **income producing factor**, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income.”

This Regulation obviously applies only to such taxpayers as **merchants** and **manufacturers** who

buy and sell or manufacture merchandise as **an income producing factor**.

A contractor does not buy and sell merchandise as an income producing factor and is not included in that category. The contractor's income is not derived from the purchase and sale of merchandise. In the case of a lump sum contract, his income is derived from the creation of a structure, which involves the supplying of all **labor, services, and engineering**, in addition to the materials that enter into the structure. He does not undertake to sell the materials as such to the owner at a profit. He undertakes to supply the materials to be used **in connection with the services and labor**, all of which are merged into the construction of a project.

The Regulation obviously cannot apply to cost, plus fixed fee contracts or cost plus a percentage of cost contracts.

Appellant does not in the Brief contend that this Regulation 41-3 is applicable. We cite it only to show that the Treasury Department only deemed inventories essential in a limited type of business.

In any event, the court below made findings of fact which are supported by uncontradicted evidence that **there were no materials on hand** at any time, **or any work in progress** to be recorded in an inventory or work in progress account. Hence, there was no necessity for maintaining such accounts. The record discloses that all materials that were purchased for a given project were in-

voiced to the owner in the monthly estimates. As soon as the owner was billed for those materials, even though not incorporated, the **title to the materials passed to the owner**. They no longer were the property of the appellee and could not under any conditions be included in an inventory account.

Even in cases where inventories are required by the Regulations, it is provided specifically that the taxpayer

“should exclude from inventory goods sold, title to which has passed to the purchaser.”

(Reg. 111, Sec. 22 (c) 1, p. 60.)

The same is true with respect to so-called work in progress. It was the uniform practice of appellee to include in the monthly estimates all the construction costs that could possibly be lawfully included under the contract, which included all the work in progress. When the estimates were approved by the engineer the amount thereof was invoiced to the owner. There was nothing left to be included in any work in progress account (assuming without admitting that such an account was necessary under the accrual system).

When such material and work in progress was invoiced it became “gross income” and was accrued as such on the books. It was in a true sense, both as to the portion presently payable, as well as the retained percentage, an “account receivable”.

When the expense was incurred in the acquisition of the materials and the creation of the work

in progress, it was accrued on the books of appellee as a cost.

There was nothing left to be included in any inventory or work in progress account. They were reflected in the accounts receivable and in the accounts payable.

The testimony of appellee and his witnesses that there were no surplus materials or work in progress which had not been included in the estimates, is uncontradicted and is supported by the fact that it was the practice to include in the estimates as much as could possibly be included because appellee was in need of money and was eager to obtain the largest payments that were legally possible under the contracts.

It is also significant that the revenue agent spent twenty-three days in examining the records of the appellee, including the duplicate monthly estimates and supporting documents, which contained a wealth of detail pertaining to the quantities of materials and labor and did not in his report or in his testimony attempt to show that there was at any time on hand any material or work in progress that had not been included in monthly estimates. The revenue agent testified that he did not know whether there were any such materials or unfinished work on hand at any time.

6.

**Re: Effect of Prior Determinations
by the Commissioner.**

The 1938, 1939, 1940 and 1941 returns were **each audited twice**. In each case determinations were made thereon, either of some deficiency or overpayment (Exh. "12" to "17" inclusive). All of the returns were on the accrual basis, based on the method of accounting uniformly employed during those years as well as the tax years in question. The method of accounting was the same throughout; no change was made in any respect whatsoever.

The Commissioner did not challenge appellee's right to adopt or maintain the accrual method of accounting or the manner in which the accounts were maintained. On the contrary, he made determinations of deficiencies and overpayments predicated thereon. We submit that those determinations have high probative value in the present controversy. No showing was made to account for the difference in the determinations.

Those determinations are entitled to the same presumption of correctness as the determinations involved in the tax years in question.

In **Hirsig v. Commissioner, Tax Court of the United States, Docket No. 6537-6538**, decision rendered August 21, 1945, Opinion by Judge Mellott, it was held:

“The conflicting determinations of the Commissioner detract from, if they do not completely nullify, any presumption of correctness otherwise attributable to them. Cf. Helvering v. Taylor, 293 U.S. 507.”

In **Bancroft v. United States, 48 F. Supp. 476-480**, the court attached significance to the fact that the Commissioner had approved an earlier return containing a declaration as to the basis of the accounting method. The court said:

“It is worthy of observation that the plaintiffs, without any change in the method of keeping their books or filing their return for the year 1939, had the approval of the Commissioner when the answer on the return showed an accrual basis.”

The court below had the right to reject the opinion of the revenue agent, Williams, that the accrual method followed by appellee was not properly maintained when the method (without change) had the approval of the Commissioner in all prior years.

II.

RE: ASSIGNMENT OF ERROR THAT DISTRICT COURT ERRED IN FINDING THAT AMOUNTS SET ASIDE UNDER THE MASON-PETERSEN PROFIT SHARING AGREEMENTS WERE PROPERLY ACCRUED DEDUCTIONS IN THE TAXABLE YEAR.

SUMMARY

a.

The assignment of error is insufficient to present any issue for consideration of the court in that it does not set out "separately and particularly each error intended to be urged" and it does not state "as particularly as may be wherein the findings of fact and conclusions of law are alleged to be erroneous" (Rule 20 (d) of this court).

b.

The court is without jurisdiction to review the order denying appellant's motion for leave to interpose the tendered set-off to the cause of action set forth in the complaint. The said order was a reviewable "decision". No appeal therefrom was taken within the time required by law and the time for such appeal had expired when the appeal from the judgment now sought to be reviewed was taken.

c.

The court below did not abuse its discretion in denying the said motion because no showing of any kind was made of mistake, inadvertence or excusable neglect or of due diligence. It was established without contradiction that appellant had full knowledge of all of the facts pertaining to the alleged set-off long before the commencement of the action.

d.

After the denial of the motion to interpose the set-off it was not a proper issue for trial in the court below, and is not now a proper issue for review.

e.

The court below did not err in holding (upon denial of said motion and in the findings) that the set-off sought to be interposed by appellant was **barred by the Statute of Limitations** and that a barred tax liability cannot be set off against a subsisting claim for refund.

f.

The court below did not err in holding on the merits of the proposed set-off that the appellee properly accrued in the tax years in question the liability to Mason and Petersen under the contracts for compensation and in taking the same as a deduction in those years.

ARGUMENT

Statement of Facts

February 3, 1942, appellee entered into an agreement with Mason, an employee, which fixed his compensation at 20% of the net profits of **"each calendar year"**. It provided for drawing \$500.00 per month with maximum withdrawals for each calendar year of \$10,000.00. The balance of the annual earnings "shall be permitted to remain in the company to be used as working capital for use in the contracting and construction business of the first party". Provision was made for termination of the contract by either party, and for maturing the time for payment of the accumulated earnings. The contract then provided:

"Should the drawing account of \$500.00 per month or \$6,000.00 per year exceed in **any calendar years** the percentage of profits to which the second party is entitled under this agreement, this difference between the amount of money to which the second party is entitled for his services on the basis of this agreement, as outlined in Paragraph I, shall be charged against any monies which have accrued to the account of the second party and the amount of money owing the second party by the first party shall be reduced by this amount."

The contract is set forth in full in the findings of fact (Tr. 28-31).

The contract with Petersen was the same except that his compensation was 15% of the net

profits of "each calendar year", the monthly drawing account was \$400.00, and the maximum drawing account for the year, \$7,500.00.

The contracts did not provide that the employees were to be responsible for any losses sustained in any calendar year; and if losses had occurred in any calendar year, they could not have been charged against the compensation earned in any preceding calendar year.

It was not alleged in the proposed set-off and no evidence was introduced that these contracts were to constitute or did constitute "Contributions of an employer to an employee's trust or annuity plan for compensation under a deferred payment plan", as provided for in Sec. 23 (p)(1)(D) of the Internal Revenue Code.

In the tax years 1942 and 1943, the two years involved at this point, both employees received in cash a portion of their earnings within the limitations fixed by the contract. The rest of their earnings measured by a percentage of the profits was credited to their accounts, charged on the books of the taxpayer as an accrued liability, and was taken by appellee as a deduction in the tax years in question.

The reasonableness of the total amount of compensation credited to the accounts of these two employees has not been questioned.

The full amounts credited to their accounts were

paid to them in cash in subsequent years (Tr. 283 and Exh. 31 and 32, Tr. 648-649).

Appellee's tax return for the calendar year 1942 was filed March 15, 1943 and the return for the calendar year 1943 was filed March 15, 1944.

The **revenue agent**, who made the report upon which the deficiency in tax was assessed and paid (plaintiff's Exhibit "20"), **knew about these contracts**. Appellant concedes that the said report was the basis of the assessment of the deficiency (Br. p. 4). The agent examined the contracts (Tr. 602-605-608); he refers to and comments upon them in the report (Tr. 461-504). **He did not report that the compensation earned by the two employees in those tax years were not proper deductions to be accrued in those years and no deficiency in tax was determined and assessed by reason thereof.**

The Revenue Agent in reality recognized that the Mason and Petersen earnings were proper deductions, because he says in his report (Tr. 608):

"It is held that all the profits of the business except for the **distribution to Mason and Petersen**, are taxable to Ross B. Hammond in his individual return."

He thus recognizes that the Mason and Petersen share of the profits was a proper deduction from appellee's profits.

The action for refund was commenced **March 16, 1946**.

July 19, 1946 (Tr. 5) appellant interposed an answer; no set-off was interposed. The Mason and Petersen transactions were not referred to. On **October 17, 1947**, (Tr. 7-8) more than three years after the filing of said returns and 17 months after the commencement of the action and 15 months after the answer was filed, appellee filed a motion for leave to interpose the tendered set-off in which it was claimed for the first time that appellee was not entitled to take any deduction for the compensation credited to the accounts of Mason and Petersen in the tax years in question; and it was claimed that by reason thereof appellee became liable for additional income tax for those years which appellant sought to offset against plaintiff's cause of action.

Neither the motion (Tr. 6) nor the affidavit of Thomas R. Winter submitted in support thereof (Tr. 7) made any showing of mistake, inadvertence or excusable neglect to account for the failure to interpose the set-off in the original answer, and made no showing of due diligence to discover the facts. **It was not alleged in the motion or affidavit that the facts were unknown to appellant.**

Appellee interposed objections to the motion as follows (Tr. 8):

- (a) Failure to make any showing of mistake, inadvertence or excusable neglect;
- (b) Failure to make showing of diligence to ascertain the facts;

- (c) That the claim upon which the alleged set-off was predicated was barred by the Statute of Limitations;
- (d) The set-off introduced for the first time an entirely new cause of action by appellant against the appellee.

The objections were supported by the affidavit of Robert T. Jacob (Tr. 9) in which he set forth the chronology of the proceedings; that the claim upon which the alleged set-off was predicated, presented a **separate and independent controversy, distinct from and unrelated to the transactions** upon which appellee's cause of action was predicated; that the Commissioner never made any determination of deficiency based upon the Mason and Petersen transactions and never assessed any tax by reason thereof; that all of the matters set forth in the amended answer were well known to appellant and to the Internal Revenue Bureau as early as November 6, 1944.

The facts set forth in the affidavit of Mr. Jacob were not contradicted.

After extended argument on the motion and the submission of extensive briefs, an order was made and entered on **November 14, 1947** (Tr. 18) denying appellant's motion to interpose said set-off.

The time to appeal from said order expired January 14, 1948.

Appellant did not take any appeal from the or-

der denying his motion to interpose the said set-off.

Upon the trial of the action, notwithstanding the denial of the motion to interpose the said set-off, appellant offered evidence in support thereof. Appellee seasonably objected thereto at every proper stage upon the grounds that the matter had been adjudicated by the entry of the aforesaid order. The court permitted the evidence to be introduced "subject to objection" (Tr. 117, 118, 126, 440, 207).

Upon the conclusion of the trial, the court below made findings of fact and conclusions of law pertaining to the said Mason and Petersen transactions and all of the proceedings relating to the attempt to interpose the set-off (Tr. 28-35, findings Nos. 19 to 24 inclusive, and conclusions of law No. 9, Tr. page 38). The findings state that notwithstanding that the evidence was admitted "subject to objection", the court reconsidered all of the objections in the light of the evidence and found "upon the merits" that the Mason and Petersen share of the profits was properly accrued and taken as deductions in the tax years in question.

The present appeal from the judgment in favor of the appellant was taken June 18, 1948, long after the time for taking an appeal from the aforesaid order had expired. The notice of appeal does not refer to the said order.

1.

Re: Sufficiency of Assignments of Error

Rule 20(d) of this court requires that appellant's brief should contain:

"A specification of errors which shall set out separately and particularly each error intended to be urged the specification shall state as particularly as may be wherein the findings of fact and conclusions of law are alleged to be erroneous."

Appellee submits that appellant's assignment of error No. II (relating to the Mason and Petersen transaction) is insufficient to warrant consideration of the questions sought to be reviewed.

The Mason and Petersen transactions involve the following of independent questions:

Is the set-off barred by the Statute of Limitations?

Can a barred claim for tax liability be set off against a subsisting claim for refund?

Did the court below abuse its discretion in denying appellant's motion?

Did appellant present a sufficient showing of mistake, inadvertence or excusable neglect?

Did appellant present any showing of due diligence to ascertain the facts and seasonably present the issue?

Was appellant entitled to take as a deduction in the tax years in question the amounts credited to the accounts of Mason and Petersen as compensation for their services?

The assignment of error presented by appellant fails to supply the particularity contemplated by the aforesaid rule of this court. The court is invited

“To retry the cause without indicating to us in such assignments in what respect or for what reason the findings or conclusions are claimed to be in error.”

(American Surety Co. v. Fischer Warehouse Co., 88 Fed. (2d) 536, 539 (9th Cir.)

2.

Re: Reviewability of the Order Denying the Motion to Interpose the Set-off Based on the Mason and Petersen Transactions

Appellee contends that the order denying leave to interpose the set-off was a reviewable decision. This court is now without jurisdiction to review the same upon the present appeal which was taken long after the time for appeal from said order expired.

Appellant did not by that motion seek to amend his answer to correct some error affecting a defense which had already been introduced, nor did he attempt to introduce an additional affirmative defense to the cause of action set forth in the complaint.

The amended answer sought to introduce a cause of action against plaintiff as a set-off to the cause of action set forth in the complaint, based

upon transactions which were independent of and unrelated to the transactions which gave rise to the cause of action set forth in the complaint.

The motion for leave to file that set-off was opposed on four grounds including the **bar of the Statute of Limitations**.

The court entered an order on November 14, 1947 denying the motion for leave to interpose that set-off (Tr. 18-19) on all of the grounds of objection urged against it.

It is now well settled that an order of this character constitutes a final appealable judgment within the purview of title, **28 U.S.C.A., 225** (Now **28 U.S.C.A., 1291**); and that if appellant desired to have the same reviewed, the jurisdiction of this court should have been invoked by an appeal therefrom within the time provided by law.

Rule 54(b), Federal Rules of Civil Procedure, (prior to amendment effective March, 1948) authorizes the entry of separate judgments on particular **claims or counterclaims** involved in a litigation and provides that:

"The judgment shall terminate the action with respect to the claim so disposed of and the action shall proceed as to the remaining claims."

In **In-A-Floor Safe Co., Limited v. Diebold Safe & Lock Co.**, 91 Fed. (2d) 341 (9th Cir.), this court entertained an appeal from an order **denying a motion for leave to file a counterclaim**. Suit was brought for patent infringement. Defendant inter-

posed an answer contesting the validity of the patent but no counterclaim was interposed. Ten months later defendant moved for leave to file an amended answer and **counterclaim**. No reasons for the delay were given. The trial court granted leave to file the amended answer but **denied leave to assert the counterclaim**. This court held:

“An order denying leave to file a counterclaim praying an injunction is an interlocutory order tantamount to one refusing an injunction, so is appealable under section 129 of the Judicial Code (28 U.S.C.A. pp. 227). *General Electric Co. v. Marvel Rare Metals Co.*, 287 U.S. 430, 433, 53 S. Ct. 202, 77 L. Ed. 408.

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“It does not appear that the court abused its discretion in the instant case. The many months’ delay after filing the answer is not attempted to be excused. On such a record we consider an appeal from an order admittedly discretionary as an unwarranted invasion on the time and energy of appellee and this court.”

So an order denying leave to interpose a set-off because it is barred by the Statute of Limitations is “tantamount” to a judgment dismissing an action based on the claim involved in the proposed set-off and is likewise an appealable order.

In *Reeves v. Beardall*, 316 U.S. 283; 62 Sup. Ct. 1085, an action was brought to recover on a note and for specific performance of a contract. The District Court dismissed the latter count on motion of the defendant. An appeal was taken from that determination although the action was pend-

ing on the first count and the contention was made that the judgment was not final and therefore not appealable. The Supreme Court of the United States held that it was appealable.

(Text of decision so far as pertinent, Appendix, page 107.)

In Western Contracting Corp. v. National Surety Corp., 163 F. (2d) 456 (4th Cir.), the court held:

“Rule 54(b) of the Rules of Civil Procedure, 28 U.S.C.A. following section 723c, made a change in existing practice to the extent of permitting final judgment, from which appeal may be taken, to be entered at any stage of a proceeding ‘upon a determination of issues material to a particular claim and all counterclaims arising out of the transaction or occurrence which is the subject matter of the claim’.”

A judgment need not conclude the litigation as a whole in order to be final for purposes of appeal.

Kasishke v. Baker, 144 Fed. (2d) 384 (10th Cir.).

U. S. v. 243 Acres of Land, 129 Fed. (2d) 678 (2d Cir.).

Rubert Hermanos, Inc. v. People of Puerto Rico, 118 Fed. (2d) 752 (1st Cir.).

Upon consideration of the motion, the court had to determine, among other things, whether the set-off was barred by the Statute of Limitations. If barred, the court was required to deny the motion.

Sunlight Carbon Co. v. St. Louis & S. F. R. Co., 15 Fed. (2d) 802 (8th Cir.).

Union Pacific Railroad Co. v. Wyler, 158
U.S. 285; 15 Sup. Ct. 877.
37 C.J. 1082, Sec. 522.
37 C.J. 1074, Sec. 511.
Brown v. New York Life Ins. Co., 32 Fed.
Supp. 443 (citing numerous cases).
Hartman v. Time, 64 Fed. Supp. 671, 680.

The court below made the determination, among other things, that the set-off was barred by the Statute of Limitations and entered an order denying the motion. This was a final determination that the appellant was not entitled to any relief upon the cause of action on which the set-off was based. The order denying the motion operated with the same force and effect as if the counterclaim had been interposed in the first instance and had been determined adversely to the appellant after a trial of the issues. It put an end to that litigation.

Being a "final determination" the order was appealable. Since no appeal was taken from the "determination" within the time provided by law, this court is now without jurisdiction to review that determination or the issues involved in the tendered set-off.

3.

The Court Below Did Not Abuse Its Discretion in Making the Order Denying the Said Motion

1.

An order denying a motion for leave to file an amended pleading interposing a new cause of action

or set-off is discretionary, and it is now settled beyond question that such an order is not reviewable except for abuse of discretion.

Appellant asserts (Br. pp. 27 and 28) that the court below abused its discretion in denying said motion (although there is **no such assignment of error**), but does not demonstrate such abuse. In this court the burden is on appellant to do so.

The appellant did not make any showing of mistake, surprise or excusable neglect in support of the motion to account for the failure to set up the set-off in the original pleading or due diligence to ascertain the facts so that he could seasonably interpose that set-off. The motion was made 17 months after the commencement of the action and 15 months after the filing of the original answer.

In opposition of the motion, appellee made an extensive showing of the history of the transactions involved and of the proceedings that preceded the making of the motion (See Affidavit of Robert T. Jacob, Tr. pp. 9 to 15). The affidavit established that the Revenue Agent knew all about the Mason and Petersen transactions and the contracts from which they arose (Tr. 12-13). The allegations of this affidavit were not denied.

Upon that record it was the duty of the court below to deny the motion. Indeed it would have been an abuse of discretion to grant it upon that record.

There can be no abuse of discretion in denying a motion to file an amended pleading (especially where it seeks to interpose a new counterclaim) when the moving party **fails to make any showing** of inadvertence, excusable neglect, mistake or due diligence.

Frank Adams Electric Co. v. Westinghouse Electric Co., 146 Fed. (2d) 165 (8th Cir.); Appendix p. 109.

Hancock Oil Co. v. Universal Oil Products Co., 120 Fed. (2d) 959, 961 (9th Cir.); Appendix p. 110.

Du Pont v. United States, 28 Fed. Supp. 122-126; Appendix p. 108.

Routzahn v. Brown, 95 Fed. (2d) 766 (6th Cir.); Appendix p. 109.

We submit that under the circumstances described in Mr. Jacob's affidavit (leaving aside for the moment the application of the Statute of Limitations), the court was fully justified in denying the motion for leave to file the amended answer. There was no abuse of discretion under the facts in this case.

There certainly can be no abuse of discretion in denying leave to interpose a **barred** claim.

In **Stafford et ux. v. Roadway Transit Co.**, 165 Fed. (2d) 920 (3rd Cir.):

"Rather we conclude that the allowance of the amendment was error because it introduced into the complaint a new cause of action which was at the time barred by the statute of limitations."

In **Stephens v. Reed**, 121 Fed. (2d) 696 (3rd Cir.), the court held:

“There can be no abuse when what is refused would avail the offeror nothing if allowed. See *Wilson v. Lamberton, et al.*, 3 Cir., 102 F. 2d 506, 507,”

4.

The Set-off Sought to Be Interposed Was Barred by the Statute of Limitations. It Was Not Error to Deny the Motion to Interpose That Set-off.

Section 26 U.S.C.A. 275a (Appendix p. 101), provides that income tax “shall” be assessed within **three years** after the filing of the return and contains the mandatory provision that:

“No proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.”

No assessment was ever made for the taxes claimed by the tendered set-off based upon the Mason and Petersen transactions.

Subdivision (c) of Section 275 (Appendix p. 101) provides that if there is an omission of “gross income” in excess of 25% of the amount stated in the return, then the limitation shall be five years.

This exception does not apply to the case at bar because it does not involve the omission of “gross income” (Sec. 22). It involves the question of “deductions” (Sec. 23).

26 U.S.C.A., Secs. 3770-3775 (Appendix pp. 101-102) (formerly Secs. 607-609 Revenue Act of 1928) prohibit the application of a barred tax liability against a subsisting claim for refund and prohibit the application of a barred claim for refund against a subsisting tax liability. They also provide that any credit of a barred tax liability against a claim for refund shall "be considered an overpayment".

The returns for the taxable years 1942 and 1943 were filed March 15, 1943 and March 15, 1944.

The three year limitation fixed by Section 275 expired **March 15, 1946** and **March 15, 1947**.

No deficiency was determined or tax assessed by the Commissioner within that period **or at all** upon the claim sought to be interposed as a set-off.

The motion for leave to interpose the set-off, based on the claim arising out of the Mason and Petersen transactions, was filed **October 17, 1947** (Tr. 6, 7), which was after the last expiration date and the claim was therefore barred.

It is uniformly held that Sections 3770 to 3775 of the Internal Revenue Act preclude the crediting of a barred tax liability against a subsisting claim for refund, and preclude the crediting of a barred claim for refund against a subsisting tax liability, in cases involving tax years subsequent to the enactment of said statutes.

McEachern v. Rose, 302 U.S. 56; 58 Sup. Ct. 84; Appendix p. 128.

- Rothensies v. Electric Storage Battery Co.**, 329 U.S. 296; 67 Sup. Ct. 271; Appendix p. 130.
- American Light and Traction Co. v. Harrison**, 142 Fed. (2d) 639 (7th Cir.); Appendix p. 131.
- Lyeth v. Hoey**, 112 Fed. (2d) 4 (2d Cir.); Appendix p. 134.
- Grand Central Public Market v. U. S.**, 22 Fed. Supp. 119-131; Appendix p. 133.
- West Virginia Pulp and Paper Co. v. McElligott**, 40 Fed. Supp. 765-771; Appendix p. 135.
- Penn v. Robertson**, 29 Fed. Supp. 386-388; Appendix p. 136.
- Rotenberg v. Sheehan**, 48 Fed. Supp. 584-587; Appendix p. 134.
- Hall v. U. S.**, 43 Fed. Supp. 130-134 (Court of Claims cert. den. 62 Sup. Ct. 944); Appendix p. 135.
- Mertens Law of Federal Income Taxation**, Vol. 10, p. 325, Sec. 58.37.
- Ronald Press Co. v. Shea**, 27 Fed. Supp. 857-863; affirmed 114 Fed. (2d) 453; Appendix p. 127.

The only case cited by appellant to overcome the bar of the Statute of Limitations is **Lewis v. Reynolds**, 284 U.S. 281; 52 Sup. Ct. 145. That case has no application because it involved the tax year 1920 which preceded the enactment of what are now Sections 3770-3775 of the Internal Revenue Code.

In a number of the cases referred to above, the courts distinguished those cases from those that involved tax years preceding the 1928 amendment of the Internal Revenue Code which enacted what is now Sections 3770-3775.

In the **McEachern** case, plaintiff sued to recover a refund and defendant interposed the set-off based upon the tax liability barred by the Statute of Limitations. The Government relied in that case upon the case of **Lewis v. Reynolds**.

The Supreme Court of the United States said:

“We may assume that, in the circumstances, equitable principles would preclude recovery **in the absence of any statutory provision requiring a different result**. But Congress has set limits to the extent to which courts might otherwise go in curtailing a recovery of overpayments of taxes because of the taxpayer’s failure to pay other taxes which might have been but were not assessed against him.” (Emphasis supplied)

Section 3770 (a) (2) (Appendix p. 101) declares that any payment of a tax after expiration of the period of limitation, shall be “considered an overpayment” and directs that it be credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim. Section 3775 (a) (Appendix p. 102) provides that any credit against the liability in respect of any taxable year “shall be void” if any payment in respect of such liability would be considered an overpayment under Sec. 3770 (a) (2). These provisions preclude the Government from taking any benefit from the taxpayer’s overpayment by crediting it against an unpaid tax the collection of which has been barred by limitation.

In the **American Light and Traction Co.** case,

the court held that the provisions of Sec. 3770-3775 "can not be ignored", and that they preclude the application of the principle laid down in the **Lewis case**.

In the **Rothensies case**, the situation was reversed. There the taxpayer sought to set off a barred claim for refund against a subsisting tax liability. The Government took the position which is the converse of the position which it now takes. It asserted the bar of the Statute of Limitations and the Supreme Court sustained the Government saying:

"We can not approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim. If there are to be exceptions to the Statute of Limitations, it is for Congress rather than for the Courts to create and limit them."

In the **Lyeth case** the Government sought to set off a barred tax liability against a subsisting claim for refund and relied upon the **Lewis case**. The court held:

"Sec. 609(a) (now 3775) prevents the Government from crediting barred taxes upon the claim of a taxpayer for overpayment of any tax and Sec. 609(b) (now 3775) in like manner protects the Government against a credit of a claim for barred taxes of any kind."

In the **West Virginia Pulp and Paper Co. case**, the court pointed out that the sections which are now 3770-3775 of the Internal Revenue Code were enacted:

“to stimulate voluntary payment of taxes by giving the taxpayer an immediate refund right **free from the danger that it will be credited against a stale deficiency.**” (Emphasis supplied)

In the **Hall case** the Government contended that the taxpayer could not set off a barred claim for refund against subsisting tax liabilities. In sustaining the Government’s position (which is the same as we take in the case at bar) the Court of Claims said:

“To permit recovery by way of recoupment under the facts as disclosed by the record would be tantamount to judicial repeal of the statutory limitation provisions (referring to Secs. 3770-3775) enacted by the Congress.”

The law is the same whether the claim for refund and the tax liability sought to be offset arose in different years or in the same tax year. (**Ronald Press Co. v. Shea**, Appendix p. 127.)

The prohibition against allowing the set-off of one against the other contained in Secs. 3770-3775 of the Internal Revenue Code, is made applicable to “any” tax and “any credit” and “any taxable year”.

The acts are not limited to taxes or credits for a **preceding** or **subsequent** year. The comprehensive word “any” is used throughout, which, of course, relates to the same year with the same force and effect as it does to a prior or subsequent year.

To limit the application of those statutes to prior or subsequent years would be equivalent to amendment of the statute.

The case of **Niles Bement Pond Co. v. United States**, 281 U.S. 357; 50 Sup. Ct. 251, is cited by appellant in support of the proposition that "the burden rests upon the taxpayer to prove all the facts necessary to establish the irregularity of the collection". That case did not involve the question of any attempted set-off against the claim for refund. The case only involved the plaintiff's own cause of action. No attempt was made in that case to wipe out or minimize the recovery by off-setting another claimed tax liability.

In the case at bar the present controversy involves the attempted assertion of a set-off based upon an alleged tax liability which was never assessed against the taxpayer and **as to which there is no presumption of correctness**. As to that attempted set-off, the defendant had the burden of **pleading and proving** the facts establishing the same. This was recognized by the appellant by the very fact that he attempted to interpose an amended answer setting up the set-off.

It is now settled beyond question that it is not error to deny a motion to interpose an amended pleading to set up a claim barred by the Statute of Limitations.

In **Sunlight Carbon Co. v. St. Louis & S. F. R. Co.**, 15 Fed. (2d) 802 (8th Cir.), the court held:

"The amendment, had it been allowed, would have amounted to the bringing of an original suit against the defendant as of that date. But at that time the cause of action stated therein was barred by the Statute of Limitations of the state.

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"Since the proposed amendment stated a new cause of action that was barred by the Statute of Limitations, the trial court did not err in refusing to allow the amendment to be filed."

In **Stephens v. Reed**, 121 Fed. (2d) 696-699 (3rd Cir.), the denial of a motion for leave to amend a pleading was assigned as error, the court held:

"There can be no abuse when what is refused would avail the offeror nothing if allowed. See Wilson v. Lamberton, et al., 3 Cir., 102 F. 2d 506, 507."

It is well settled that a new claim interposed by an amended pleading based upon a transaction, distinct from the transaction which is the subject of the former pleading, amounts to the commencement of a new action as of the date when the amended pleading is tendered. **It does not relate back** to the date of the original pleading under Rule 15 (c) F. R. C. P.

Ronald Press Co. v. Shea, 27 Fed. Supp. 857-863 (affirmed 114 Fed. (2d) 453).

Sunlight Carbon Co. v. St. Louis & S. F. R. Co., 15 Fed. (2d) 802 (8th Cir.).

Hammond-Knowlton v. U. S., 121 Fed. (2d) 192 (2d Cir.).

Hartman v. Time, 64 Fed. Supp. 671-680.

**Brown v. New York Life Ins. Co., 32 Fed.
Supp. 443-444.
37 C.J., p. 1082, Sec. 522.
37 C.J., p. 1074, Sec. 511.**

The claim sought to be set off by appellant in the proposed amended answer was separate and distinct from the transaction involved in appellee's cause of action, set forth in the complaint.

The original answer contained no counterclaim or set-off at all. There was no set-off to be amended.

The tax which was assessed against appellee and paid by him and which is the subject matter of the appellee's cause of action resulted from:

- (a) An attack (now abandoned) upon the partnership between appellee and his son, William.
- (b) The contention that appellee should have maintained his books of account and reported income on the "percentage of completion" basis instead of the "accrual basis".

The Mason and Petersen transactions were not involved in the assessment of the tax which is the subject matter of the appellee's cause of action.

The set-off sought to be interposed involves only the interpretation of the contracts between Mason and Petersen and the appellee to determine whether appellee properly took as deductions the amounts credited on the books to Mason and Petersen for services rendered in the tax years in question.

Since the tendered set-off is unrelated to the appellee's cause of action and introduced a new set-off or cause of action against appellee, the **Statute of Limitations ran against that set-off until it was tendered** and does not relate back to the time of the commencement of the action or the time of the filing of the original answer under Rule 15 (c) F. R. C. P.

5.

The Finding of Fact of the Court Below That the Appellee Properly Took as a Deduction in the Tax Years in Question the Amounts Credited to the Accounts of Mason and Petersen Is Sustained by the Uncontradicted Evidence and the Conclusion Based Thereon Is Sound as a Matter of Law.

The contracts are set forth in full in the findings of fact (Tr. 28-32). The court below made findings of fact (Tr. 32 and 33) that the share of the profits credited to their accounts were "earned" by said Mason and Petersen in the tax years in question and accrued on the books of the company in those tax years; that the contracts were made in good faith; that the profits so accrued to them "were proper deductions in the said tax years as expense, and that the said profits were subsequently paid to them in cash".

These findings of fact are **not challenged by any assignment of error or in the brief**. They are fully supported by the evidence. The Revenue

Agent did not in his report (plaintiff's Exhibit "20") reject these accruals, and no evidence was introduced to explain why it was improper to take the deductions.

Plaintiff's Exhibits "31" and "32" (Tr. 648-9) are the ledger accounts of Petersen and Mason and show that their share of the profits was credited to their accounts in the tax years in question and show the dates when payments were made thereon.

Appellant argues that Mason and Petersen did not "constructively receive" the income credited to their accounts and accrued as liabilities in the tax years in question.

The question of "constructive receipt" is not involved in this case. The fiction of "constructive receipt" is indulged in when accounts are maintained on the "cash basis".

It is designed to prevent tax evasion by failing or refusing to receive income when it can be received as a matter of right to postpone the tax thereon to a later tax year.

The fiction of "constructive receipt" has no place in an accrual method of accounting because the accrual method deals only with "accounts receivable" and "accounts payable" and not with "actual" or "constructive" receipts. It "ignores due dates".

It is argued that Mason and Petersen did not have an unrestricted right in the tax years involved

to demand payment of the amounts credited to their accounts. That is wholly irrelevant. We are not concerned with the question when payment was **due**. We are only concerned with the question when appellee's "obligation to pay" accrued.

Under the accrual system if a fixed liability is created in a given year, it must be accrued in that year regardless of the time when the liability is to be paid.

Appellant also points out that Mason and Petersen did not report the income in the tax years in which appellee accrued the liability on his books. That, too, is irrelevant because it appears from the record that Mason and Petersen did not report income on the accrual basis. They were on the cash basis (Exh. 26, Tr. 621-623, and Exh. 27, Tr. 627-630) and were therefore required to report their income **when received** by them and not when it was earned and accrued on the books of the taxpayer.

Mr. Williams, the revenue agent, examined the Mason and Petersen agreements and knew of the deductions. **He did not give any testimony as to why it was improper to deduct the amounts credited to the account of Mason and Petersen as expense of the operations in the years in which the deductions were made.**

The appellant contends that the liability to Mason and Petersen at the end of each year was contingent and therefore not properly accrued as expense. The argument seems to be that because

Mason and Petersen contracted to "permit" a part of their earnings to be utilized by appellant to finance the operations of the business, that the amount of profit earned could not be accrued in the years in which they were earned and credited to their accounts, but should have been credited to their accounts and taken as deductions in the year when paid.

Section 1 of the contract (Tr. 29), which permitted a portion of Mason and Petersen's compensation to remain unpaid and to be utilized by appellee in the business, did not make contingent the liability of appellee to Mason and Petersen. The liabilities became fixed and complete at the end of "each calendar year". Nothing except payment could thereafter affect that liability. **Each year was a distinct unit** for the purpose of determining the earnings for that year, and the result of subsequent years' operations could not diminish the liability created in the preceding year or years.

The time for payment could be matured by the employee by giving one year's written notice of intention to withdraw "the earnings accumulated to his account" (Tr. 30).

Section 3 provides that if the withdrawals during any calendar year exceed the percentage of profits to which the employee is entitled during such calendar year, the difference "shall be charged against any monies which have accrued to the account" of the employee and "the amount of money

owing the second party (employee) by the first party (employer) shall be reduced by this amount”.

This is the provision which appellant claims renders the compensation contingent.

Appellant obviously misconstrues this provision. The provision for charging the employee's account with overdrafts in a succeeding year merely operates as **payment pro tanto** of the liability theretofore created to the extent of such overdraft in the subsequent year.

The transaction was in effect a loan or extension of credit by the employees to their employer. They were his bankers to the extent of the unpaid portion of their earnings. The liability once created became fixed and was not subject to any conditions.

That liability could, of course, be reduced or satisfied by subsequent withdrawals by the employee in excess of the amount to which he was entitled. But that merely results in payment and nothing more.

In **Lamm Lumber Co. v. Commissioner of Internal Revenue**, 45 B.T.A. 1-9, the taxpayer corporation fixed the salary of W. E. Lamm at \$24,000.00 a year. Because of financial difficulties the affairs of the corporation were placed in the hands of a bank with the right to control operations including the amount of salary to be disbursed. The bank limited Lamm's withdrawals to \$10,000.00 a year. The balance of the annual salary was credited to Lamm's account and carried on the books of the

company as an account payable. The corporation was on the accrual basis and took as a deduction in each year the full amount of \$24,000.00. The Commissioner disallowed the deduction in excess of the \$10,000.00 paid annually, claiming that the balance was not properly accruable. The court held:

“The liability of petitioner for the salary accrued is established by the directors’ action in 1926. The accrued but unpaid salary was and is carried as an account payable to Lamm, who testified that the indebtedness had not been forgiven and that he expected to collect the same. Delay in payment can not defeat the accrual where **all events had happened which fixed the liability**. The personal services were rendered by Lamm in 1936 and the liability accrued in that year. We are of the opinion that the accrual herein was proper and that the deduction of \$24,000 should be allowed.”

In **Tyler v. Hippach, Inc., 6 B.T.A. 636**, the court held:

“The amount of such compensation was definitely calculable and was a fixed and legal obligation. It was an obligation **related directly and solely to the business of the particular year for which the compensation was contracted to be paid.**”

Sec. 3 of the contract does not render the obligation contingent because the employees were **not to be charged with any losses that might be sustained in subsequent years**. They were chargeable only with overdrafts beyond the amount that they would be entitled to receive in subse-

quent years. If the employers sustained losses in subsequent years it would only result in the employees receiving no compensation for their services in the subsequent years. But such losses would not affect the liability of the employer to the employees for the compensation earned in preceding years. If in a subsequent year the employees did not become entitled to any compensation, any monies that they received in the subsequent years would be an overdraft which, even in the absence of a contractual provision, could be offset against the employer's liability to them. Since the operations in subsequent years could not affect the liabilities accrued in prior years, there is no basis for the contention that the liability was contingent.

Not a single case is cited in which a provision similar to the one contained in paragraph 3 of the contracts is to be deemed a contingency affecting liability within the meaning of the Internal Revenue Code. None of the cases cited on page 25 of appellant's brief lends any support to such an idea.

It is true that under the contract Mason and Petersen did not have the right to demand payment in full in the calendar year in which the amount of their share of the profits was accrued. That is not the test of accruability. The liability was complete in the tax year in question. They rendered the services for which the compensation was fixed in the tax years in question. The liability was not made to depend upon the occurrence of some contingency. Only the time of payment was postponed.

It is the very essence of the accrual method of accounting that it takes no account of the due date. (**Willoughby v. Commissioner**, 125 Fed. (2d) 607.) It concerns itself only with the accrual of the liability.

It is not true as asserted by appellant (Brief, p. 25) that the amounts credited to the accounts of Mason and Petersen were "plowed back into the business" and were "not definite obligations of the taxpayer". While the contract permitted the taxpayer to use the unpaid portion of the compensation in his business, the contract does not contemplate that the liability to Mason and Petersen was to be jeopardized by the use of the money in the business. It was not stipulated that in the event that the money was used in the business and losses resulted, the obligation should be reduced or wiped out to the extent of such loss. The taxpayer was not to speculate with such funds at the risk of the employees. He was merely permitted to use those funds in his business to the same extent as he would be authorized to use money which he borrowed from a bank for use in his business. The liability to the bank would not be affected by the fact that the bank knew or agreed that the moneys loaned were to be used in the business of the borrower. The obligation to pay would be unaffected, and therefore the permission to use the retained portion of the compensation in the business of the taxpayer did not render the obligation "contingent".

It is not true, as asserted in appellant's brief (p. 26) that the employee's additional compensation was faced with "two contingencies—his remaining in the business and the continued success of the business". The former provision, "remaining in the business," does not create a contingency. It gave the employee the absolute right to fix the date of payment. The employee had the right to fix the date of payment by giving the required notice, and the employer had the right to fix the date of payment by giving the required notice. A provision which merely creates an absolute right to fix a date of payment cannot be, and is not, a contingency affecting the liability. No authority is cited in support of that contention.

As to the second alleged contingency, "continued success of the business," we have already demonstrated that the liability is unaffected by profit or loss in succeeding calendar years, because the employee is not required to contribute any part of the losses sustained by the taxpayer in a subsequent calendar year.

There is no presumption of correctness in favor of appellant with respect to this issue. No determination of any deficiency in tax was made by the Commissioner, and no tax was assessed by reason of the Mason and Petersen transactions. The burden of proof that the deductions referred to were not properly taken in the tax years in question was upon the appellant (assuming it was properly an issue in the case). There is not a scintilla of

evidence in the record that would sustain a finding of fact that the deductions were improperly taken.

Indeed, it can with propriety be urged that there is a presumption of correctness in favor of the appellee upon this issue because the Commissioner actually made a determination of the tax liability for the tax year in question. He assessed a deficiency in tax upon the partnership issue and the method of accounting issue, but made no determination adverse to the taxpayer based upon the Mason and Petersen transactions, although the Commissioner was aware of the facts pertaining to said transactions, and they had been fully examined into as disclosed by the revenue agent's report (plaintiff's Exhibit "20"). Under these circumstances, it can properly be said that there is a presumption that the deductions taken in the tax years in question, based upon the Mason and Petersen transactions, were proper.

It is now well settled that under the accrual method of accounting the time when the liability becomes fixed determines the time when the deduction is to be taken. The time when the obligation is payable does not affect the time when the deduction is to be taken.

J. H. Martinus & Sons v. Commissioner, 116 Fed. (2d) 732 (9th Cir.).

Cecil v. Commissioner, 100 Fed. (2d) 896 (4th Cir.).

U. S. v. Utah-Idaho Sugar Co., 96 Fed. (2d) 756, 759 (10th Cir.).

Brown v. Helvering, 291 U.S. 193; 54 Sup. Ct. 356.

U. S. v. Anderson, 269 U.S. 422; 46 Sup. Ct. 131, 134.

American Natl. Co. v. U. S., 274 U.S. 99; 47 Sup. Ct. 520.

Ohmer Register Co. v. Commissioner, 131 Fed. (2d) 682 (6th Cir.).

Willoughby Camera Stores v. Commissioner, 125 Fed. (2d) 607 (2d Cir.).

Merten's Law Fed. Inc. Taxation, Vol. 2, p. 218, Sec. 12.63.

Helvering v. Russian Finance & Construction Corp., 77 Fed. (2d) 324 (2nd Cir.).

In the **Martinus** case, *supra*, the court held:

"In a case like the present, where a corporation maintains its accounts on the basis of cash receipts and disbursements, reasonable salaries actually paid to officers are entitled to be deducted in the year in which the payment is made. **Conversely, taxpayers keeping their accounts and making their returns on an accrual basis may deduct salaries accruing although not paid during the tax year.**" (Emphasis supplied)

In the **Cecil** case, *supra*, the court held that the word "accrual" as used in the Internal Revenue Act

" * * * refers to the time when the liability becomes fixed rather than when it is payable." (Citing numerous authorities.)

In the **Utah-Idaho Suga Co.** case, *supra*, the court held:

"The incurring of the right to receive and of the obligation to pay definite and fixed sums accrue items for income tax purposes where books are kept and returns made on the ac-

crual basis. Actual receipt and actual payment are not essential." (Citing several United States Supreme Court cases.)

In the **Brown case**, *supra*, the Supreme Court of the United States said that where accounts are kept on the accrual basis a liability incurred in the current taxable year may be treated as an expense incurred and may be taken as a deduction

"although payment is not presently due." (Citing numerous cases.)

In the **American National Co. case**, *supra*, the taxpayer issued bonus contracts to persons who had purchased mortgage notes. The contracts provided for the payment of specific bonuses over a period of years. The taxpayer, who kept its books on the accrual basis, accrued the entire bonus liability that would be due over the period of years and took the total amount so accrued as a deduction in the tax year in which the contract was made. The Supreme Court of the United States held that the total amount of the bonus was deductible in the year in which the contract was made,

"although not due and payable until the expiration of two years."

In the **Willoughby case**, *supra*, the taxpayer, who was on the accrual basis, took deductions for the amount of employees' bonuses which were accrued on the books as liabilities in the tax years in question but were not payable until the following year,

and the court held that the fact that no date for payment is fixed does not affect the accruality and the deductibility of an item of expense under the accrual system of accounting, and that

“the accrual system wholly disregards due dates.”

In **Helvering v. Russian Finance and Construction Corp.**, *supra*, the taxpayer, who was on the accrual basis, agreed to purchase six hundred thousand tons of ore, and to pay therefor a fixed price scale plus a bonus of \$2.00 per ton to be paid at the expiration of ten years from the date of the agreement. The taxpayer received the six hundred thousand tons of ore in the first three years. It accrued the full liability for the bonus in the 3 years in which the ore was purchased and took a deduction therefor in those years. The court, in sustaining the right of the taxpayer to the deduction, among other things said,

“* * * That the liability may not subsequently be discharged by payment does not necessarily prevent its consideration as a liability for the years accrued. See **Peyton-Dupont Sec. Co. v. Commissioner**, 66 Fed. 2d, 718 (2d Cir.). The possibility that a present liability may subsequently be discharged by some **condition subsequent** does not prevent its accrual on the taxpayer's books. * * * The taxpayer's liability became fixed upon delivery of the ore and there then existed reasonable grounds to justify the taxpayer in believing that it would ultimately have to pay the \$1,200,000. A presently existing obligation which the taxpayer has reasonable grounds to believe must

eventually be fulfilled, is not uncertain or contingent in the sense that it may not be accrued. See **Automobile Ins. Co. v. Commissioner**, 72 Fed. (2d) 265 (2d Cir.).

.

“When books are kept on an accrual basis a presently existing obligation which in the normal course of events the taxpayer is justified in believing he must fulfill may be accrued.”

In **Ohmer Register Co. v. Commissioner**, *supra*, the taxpayer entered into agreement with sales agents to pay them commissions upon sales at fixed rates. The commissions were to be paid however as and when the customers made payments for the merchandise sold by the agents. The contracts contained provisions for the making of certain adjustments under varying conditions, which would ultimately affect the amount of the commissions in the event of the occurrence of the conditions described in the contract. The taxpayer who kept its books on the accrual basis accrued the entire commission in the tax year in which the sale was made although the commissions were in part payable in subsequent tax years. In making its income tax return, it took as a deduction the total amount of the commission due under the contract, instead of the part of the commission that was payable during the tax year for which the return was made. The Commissioner disallowed the deductions for commissions which were due and payable in the subsequent year and based thereon assessed a deficiency in tax. The court held:

"The Board of Tax Appeals conceded, also, that the **taxpayer may deduct**, as **expense** incurred, a **liability** which has **accrued** during the taxable year, 'although payment is not presently due.'

.

"Corresponding, the **right to deduct** an expense item **accrues when** the fixed **obligation is incurred**, even though the amount may be diminished by subsequent events. **Both sides of the ledger must be treated alike.**

.

"In our judgment, the net income of the petitioner for the taxable year involved could not have been correctly determined upon the accrual basis, without deducting the commission expense from gross income. The method adopted clearly reflected the taxpayer's true income (*American National Company v. United States*, 274 U.S. 99, 47 S. Ct. 520, 71 L. Ed. 946), upon scientific accounting principles. (*United States v. Anderson*, 269 U.S. 422, 440, 46 S. Ct. 131, 70 L. Ed. 347).

"The items of **commission** expense claimed as deductible under Section 23 of the Revenue Act **were not contingent** liability but were **definitely incurred** and fixed liabilities within the taxable year."

Merten's Law Fed. Inc. Taxation, supra, says:

"Where a share of profits is definitely committed to an employee, and where those profits could be reasonably determined and **only the enjoyment** of the compensation is **postponed** or the amount to be paid is subject to later revision, an obligation is incurred which may be the basis for a deduction."

Under these decisions, the provision in the con-

tract in the case at bar deferring the payment of part of the compensation cannot be said to render the liability contingent.

In **Kaufman Department Stores v. Commissioner of Internal Revenue**, 34 Fed. (2d) 257 (3rd Cir.), cited by appellant, the bonus agreement provided for the payment of additional compensation of two per cent of the "final net profits" earned over an **entire period of five years**, payable at the end of that period. The taxpayer accrued at the end of each year the bonus of two per cent upon the profits earned during each year. Under that agreement the liability for any bonus in any one year could not be determined until the expiration of the full period of five years because subsequent years operations could reduce or wipe out the bonus. In the case at bar, however, the liability accrued and became fixed at the end of each year. The amount thereof could not be diminished or wiped out by anything that took place thereafter.

The **Kaufman** case is typical of the rest of the decisions cited by appellant.

6.

Re: Application of Section 23 (p) (1) (D) Internal Revenue Code

It is now urged (appellant's brief, pages 26-27) that Section 23 (p) (1) (D) of the Internal Revenue Code precluded appellee from taking as a deduction the Mason and Petersen compensation in

the tax year in question.

This contention was not made in the Revenue Agent's report (Plff. Exh. 20).

This contention was not raised by the proposed set-off tendered by appellant with the motion for leave to file the same.

The proposed answer did not allege in words or effect that the contracts between Mason and Petersen and the taxpayer constituted **"contributions of an employer to an employee's trust or annuity plan and compensation under a deferred payment plan"**.

Section 23 (p) is a comprehensive statute dealing, as the title indicates, with stock bonus, pension, profit sharing or annuity plans and relates primarily to the employer's "contributions" to the plan. It does not relate to ordinary contracts between employer and employee for the payment of compensation measured by commissions or share of the profits as the primary compensation. Regulation 111, page 169, specifically exempts compensation contracts from the operation of Section 23 (p).

The regulation says:

"If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision

is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year."

This interpretive regulation was obviously designed to remove any question about the application of Section 23 (p) to ordinary contracts for compensation which do not have "the effect of a stock bonus, pension, profit-sharing or annuity plan".

Appellant cites no authority for the application of Section 23 (p) of the Internal Revenue Code to the case at bar. The senate report referred to does not support appellant's contention. On the contrary it clearly negatives that conclusion. The report reads as follows:

"If an employer on the accrual basis defers paying any compensation to the employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing or annuity plan, or similar plan deferring the receipt of compensation, he will not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payments of compensation after the year of accrual merely because of inability to pay such compensation in the accrual year."

This statement in the report is substantially like the aforesaid quotation from Regulation 111, and the provision in the regulation was apparently inserted to carry out the precautionary observation in the Senate Report.

The provision in the contracts in the case at bar deferring the payment of part of the compensation for services was not inserted as a part of a contribution, pension, annuity et cetera plan.

CONCLUSION

The judgment appealed from should be affirmed.

Respectfully submitted,

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Attorneys for Appellee.

APPENDIX

All emphasis in quotations from statutes and decisions are supplied.

1.

Statutes and Regulations Involved.

26 U.S.C.A., Sec. 275:

“(a) **GENERAL RULE.**—The amount of income taxes imposed by this chapter shall be assessed within **three years** after the return was filed, and no proceeding in court **without assessment** for the collection of such taxes shall be begun after the expiration of such period.

.

“(c) **OMISSION FROM GROSS INCOME.**
—If the taxpayer omits from **gross income** an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.”

26 U.S.C.A., Section 3770, provides:

“(1) **Assessments and collections generally**
—Except as otherwise provided by law in the case of income, estate, and gift taxes, the Commissioner, subject to regulations prescribed by the Secretary, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to

be unjustly assessed or excessive in amount, or in any manner wrongfully collected.

“(2) Assessments and collections after limitation period. Any tax (or any interest, penalty, additional amount, or addition to such tax) assessed or paid after the expiration of the period of limitation properly applicable thereto shall be considered an overpayment and shall be credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim.”

26 U.S.C.A., Section 3775 provides:

“§ 3775. Credits after periods of limitation.

(a) Period against United States. Any credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment under section 3770(a) (2).

(b) Period against taxpayer. A credit of an overpayment in respect of any tax shall be void if a refund of such overpayment would be considered erroneous under section 3774. 53 Stat. 466.”

Section 41, of the Internal Revenue Code (26 U.S.C.A. 41) provides:

“The net income shall be computed upon the basis of taxpayer’s annual accounting period. . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; . . . or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.”

Reg. 111, Section 29.41 - 1, page 253, provides:

"COMPUTATION OF NET INCOME. . . .

The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. **If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.** (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

Reg. 111, Section 29.41-2, page 253, provides:

"BASES OF COMPUTATION AND CHANGES IN ACCOUNTING METHODS.—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are **treated with reasonable consistency.** See section 48 for definitions of 'paid or accrued' and 'paid or incurred.' **All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly,** unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method.

.

"The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return.

.

"A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for the purposes of taxation, secure the consent of the Commissioner. For the **purposes of this section**, a **change** in the method of accounting employed in keeping books **means any change in the accounting treatment** of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see sections 29.22(c)-1 to 29.22(c)-8, **inclusive**); a **change from the cash or accrual method to the long-term contract method**, or vice versa; a **change in the long-term contract method from the percentage of completion basis to the completed contract basis**, or vice versa (see section 29.42-4). . . ."

Reg. 111, Section 29.41-3, page 255, provides:

"METHODS OF ACCOUNT.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and **the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose**. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as

will enable him to do so. (See section 54 and section 29.54-1.) Among the essentials are the following:

“(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and sections 29.22(c)-1 to 29.22(c)-8, inclusive.”

Section 42 of the Internal Revenue Code (26 U.S.C.A. 42) provides:

“The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41 any such amounts are to be properly accounted for as of a different period.”

Reg. 111, Section 29.42-1, page 257, provides:

“WHEN INCLUDED IN GROSS INCOME.
—(a) In General.—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See sections 29.41 to 29.41-3, inclusive.)”

Reg. 111, Section 29.42-4, page 260, provides:

“Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the

nature and terms of the particular contract. As used in this section the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

“(a) Gross income derived from such contracts **may** be reported upon the basis of **percentage of completion**. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, **account being taken of the material and supplies on hand at the beginning and end of the taxable year** for use in connection with the work under the contract but not yet so applied.

“(b) Gross income **may** be reported for the taxable year in which the contract is **finally completed** and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.”

Section 43 of the Internal Revenue Code (26 U.S.C.A. 43) provides:

“The deductions and credits . . . provided for in this chapter shall be taken for the taxable year in which ‘paid or accrued’ or ‘paid or incurred’, dependent upon the method of accounting upon the basis of which the net income is computed unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.”

Section 29.43-1, page 264, provides:

“ ‘PAID OR INCURRED’ AND ‘PAID OR ACCRUED.’—(a) The terms ‘paid or incurred’ and ‘paid or accrued’ will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which ‘paid or accrued’ or ‘paid or incurred,’ unless in order clearly to reflect the income such deductions or credits should be taken as of a different period.”

Section 48 of the Internal Revenue Code (26 U.S.C.A. 48) provides:

“The terms ‘paid or incurred’ and ‘paid or accrued’ shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.”

2.

Re: Appealability of Order Denying Leave to Interpose Set-off

In Reeves v. Beardall, 316 U.S. 283; 62 Sup Ct. 1085, an action was brought to recover on a note

and for specific performance of a contract. The District Court dismissed the latter count on motion of the defendant. An appeal was taken from that determination although the action was pending on the first count. The contention was made that the judgment was not final and therefore not appealable. The Supreme Court held:

“After the entry of the judgment on Count II, the claim based on the contract not to change the will was terminated and could not be affected by any action which the Court might take as respects the remaining claims. Nothing remained to be done except appeal.”

3.

Re: Abuse of Discretion

In **Dupont v. United States**, 28 F. Supp. 122-126 (an action to recover a tax refund), the court in denying a motion by the United States to interpose a similar defense under similar circumstances, as in the case at bar, said:

“The whole subject was very fully discussed in **Routzahn v. Brown**, 6 Cir., 95 F. 2d 766. In that case a similar amendment was offered and refused after judgment in favor of the Collector and reversal by the Circuit Court of Appeals, but before a second trial. The court pointed out that the matter is discretionary, calls for the application of equitable principles, and that under the circumstances of that case **there was no inequity or abuse of discretion in denying the amendment.**

“This case does not present a situation quite so strongly against the request to amend,

but I think the equities are quite sufficient to require denial of it. **It does appear** that no specific notice was given of the purpose of the Government to raise the question of deductibility of any items other than those which have been already discussed, and **that the Treasury Department, after audit and investigation, sent the plaintiff a copy of an official report relating to the year 1932, in which there expressly appeared the deduction of the secretary's salary.** The Government filed its original answer in October, 1937, and filed an amended answer more than three months before the trial. **There is not the slightest suggestion of fraud or concealment on the part of the taxpayer.** Under all these circumstances I think it proper to deny the proposed amendment."

In **Routzahn v. Brown**, 95 F. (2d) 766 (6th Cir.), the case referred to by the District Judge in the **Dupont case**, the court, in sustaining the action of the court below in refusing to permit amendment of the answer to introduce a similar set-off, said:

"It is to be expected that a defendant will submit to the court in the first instance all defenses in derogation of the plaintiff's right to recover that are known to him, or which in the exercise of diligence he should have known, and indeed in equity cases the rules, Rule 30, 28 U.S.C.A. following section 723, seem to require it."

In **Frank Adam Electric Co. v. Westinghouse Elec. Mfg. Co.**, 146 Fed. (2d) 165 (8th Cir.), the court held:

"Considering the failure of the defendant to show that its long delay in tendering its counterclaim and its second amendment was

due to oversight, inadvertence, or excusable neglect, we can not say that the court abused its discretion in refusing amendments."

In **Hancock Oil Co. v. Universal Oil Products Co.**, 120 F. (2d) 959-961 (9th Cir.), the court held:

"Whether or not this amendment would be allowed was in the sound discretion of the trial court, and the decision of that court will not be reversed except for an abuse of its discretion.

.

"The proposed amendment to the counterclaim sought to set up as an **additional ground of counterclaim** an alleged violation of the Clayton Act, 15 U.S.C.A. § 15.

.

"No attempt was made to show diligence on the part of Hancock to ascertain the facts alleged in the proposed amendment to the counterclaim, or to keep in touch with other suits involving the patents here involved."

.

"In the circumstances we are unable to hold that the District Court abused its discretion in refusing leave to amend."

4.

Re: Burden of Proof and Presumption of Correctness

In **Whitney v. Commissioner**, 73 F. (2d) 589, 591 (3d Cir.), the court held:

"The burden of proof was on the petitioner before the Board, and if he met it, the burden shifted and the government was require to come forward with evidence to refute the evi-

dence of the petitioner. It did not do so and the Board cannot draw inferences and conclusions from facts or suppositions outside of the record."

In **Helvering v. Talbott's Estate**, 116 F. (2d) 160 (4th Cir.), the court held:

"When such evidence is adduced, the Commissioner's finding is no longer entitled to probative force and the authority of the Board to make the controlling decision is complete."

In **Hemphill Schools v. Com'r of Internal Revenue**, 137 F. (2d) 961-964 (9th Cir):

"Evidence having been so produced, the **presumption ceased**, and thenceforth the issue depended wholly upon the evidence.' It thus became the duty of the Board to find from the evidence, and **from it alone**, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption (**which no longer existed**) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it."

In **Lunsford v. Commissioner of Internal Revenue**, 62 F. (2d) 741-742 (6th Cir.), the court held:

"The **presumption** that the Commissioner is right is **procedural** and cannot **survive such proofs** unless they are challenged by contrary proofs, or destructive analysis, and we have gone so far as to say that the taxpayer's affirmative evidence may itself contain the necessary challenge and furnish the material for such analysis."

In **Clinton Cotton Mills v. Commissioner**, 78 F. (2d) 292-295 (C.C.A. 4), the court held:

“ . . . where it appears that the method pursued by the Commissioner is erroneous, the presumption of the correctness of his determination no longer avails. **Russell v. Commissioner** (C.C.A. 1st) 45 F. (2d) 100, 103.”

In **Russell v. Commissioner**, 45 F. (2d) 100-103 (C.C.A. 1), the court held:

“While there is a presumption that the Commissioner’s findings are correct, **Avery v. Commissioner** (C.C.A.) 22 F. (2d) 6, 55 A.L.R. 1277, when it appears, as in this record it does appear, that the methods pursued by the Commissioner were mathematically and legally erroneous, that presumption no longer avails. **New York Life Ins. Co. v. Ross** (C.C.A.) 30 F. (2d) 80, 82.”

5.

Re: Accrual Method of Accounting

In **Security Flour Mills Co. v. Com’r of Int. Rev.**, 321 U.S. 281; 64 S. Ct. 596 (1944), the Supreme Court of the United States had before it the question of the interpretation of Sections 41 to 43 of the Internal Revenue Code. The case involved the question of the **allocation of income and deductions under the accrual method** of accounting. The court held.

“The propriety of the claimed deduction depends upon the construction of Sections 23(a), 41 and 43 of the Revenue Act of 1934.”

After summarizing the provisions of Sections 41 and 43, of the Revenue Act, the court went on to say:

“It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent.”

.

“Petitioner nevertheless insists that Section 43 of the Revenue Act, which requires that deductions be taken for the taxable year in which the amount was paid or accrued, creates an exception applicable to this case by its concluding clause, ‘unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.’ In short, the petitioner’s position is that the Commissioner and the Board of Tax Appeals are authorized and required to make exceptions to the general rule of accounting by annual periods wherever, upon analysis of any transaction, it is found that it would be unjust and unfair not to isolate the transaction and treat it on the basis of the long term result. **We think the position is not maintainable.**”

.

“But we think it was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer.

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"The rationale of the system is this: 'It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.'

"This legal principle has often been stated and applied. The **uniform result has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt of payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.**

"But the petitioner urges that Section 43 has altered the rule so that a **hybrid system, partly annual and partly transactional**, may, within administrative discretion, be substituted for that of annual accounting periods. It urges that the change was due to the desire of Congress to prevent distortion of true income. This must mean distortion of true income, not of a **given year**, but, in the light of ultimate gain, from a **series of transactions over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year.** The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation.

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"We are of opinion that the **purpose of the language which Congress used was not to substitute**, whenever in the discretion of an administrative officer or tribunal such a course would seem proper, a **divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system."**

In **Helvering v. Enright's Estate**, 312 U.S. 636; 61 S. Ct. 777, the court held:

“ ‘Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the **right to receive** and not the actual receipt that determines the inclusion of the amount in gross income.’ ”

In **Spring City F. Co. v. Commissioner of Int. Rev.**, 292 U.S. 182; 54 S. Ct. 644, the court held:

“Keeping accounts and making returns on the **accrual basis**, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. **When the right to receive an amount becomes fixed, the right accrues.**”

In **Frost Lumber Industries v. Commissioner of Int. Rev.**, 128 F. (2d) 693-694 (5th Cir.), the court held:

“In that view where the **taxpayer's books** are kept on an **accrual basis**, where the amount is reasonably certain in fact and determinable in amount, it **may be treated as a gain or a loss even though the exact amount may not have been precisely ascertained.** *United States v. Anderson*, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347; *Lucas v. American Code Company*, 280 U.S. 445, 50 S. Ct. 202, 74 L. Ed. 538, 67 A.L.R. 1010. Though the computation may be undetermined, if the **basis for the computation is unchangeable** and though the exact amount **may be unknown**, if it is not unknowable, the item in such cases is **to be treated, for tax purposes, as accrued income.** *Uncasville Manufacturing Company v. Commissioner*, 2 Cir., 55 F. 2d 893. In *Spring City Company v. Commis-*

sioner, 292 U.S. 182, 54 S. Ct. 644, 645, 78 L. Ed. 1200, the court said: 'Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the **right to receive** and **not the actual receipt** that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed the right accrues.' "

In **Pfeiffer v. Jones**, 57 F. Supp. 621-623, Appeal Dismissed, 146 F. (2d) 1002, plaintiff leased oil lands to an oil company in 1936. The leasee agreed among other things to pay plaintiff a **bonus of \$54,000.00**, approximately **one-third in cash** at the time of the agreement, **one-half of the balance** to be paid in 1937 and one-half of the balance to be paid in 1938. Plaintiff kept his books and made his income tax returns on the accrual basis. He **reported the whole of the \$54,000.00** as income in 1936 and paid the tax thereon. The Commissioner determined that the portion of the bonus to be paid in 1937 and 1938 was not income in 1936. He refunded the portion of the tax paid on the accrued income and assessed a deficiency in tax for the subsequent years, treating the payments made in 1937 and 1938 as income in those years. Plaintiff paid the assessment and sued for refund. The court made **conclusions of law** as follows:

"Second. That the \$54,000 bonus for the execution of said Oil and Gas Lease was taxable income of the plaintiff for the calendar year 1936, the year of the execution of said lease, the taxpayer being on an accrual basis and such bonus being unconditionally guaran-

teed by an enforceable contract in writing executed by a solvent obligor, whose credit was unquestioned. That the Commissioner erred in determining that part of said bonus was income for the calendar year 1937, and the Commissioner was further in error in determining that part of said bonus was income for the calendar year 1938. That the Commissioner was in error in making said deficiency assessments."

In **United States v. Detroit Moulding Corporation**, 56 F. Supp. 754-757, the court held:

"Where, as here, in accrual accounting by calendar year periods for income tax purposes, all the events occur within a calendar year which fix the amount and the fact of a taxpayer's liability for an excise tax accrued though not paid, which liability is neither contested by the taxpayer nor contingent and not changed within a reasonable time after the close of the calendar year, proper accounting practice requires that such liability be accounted and deducted as accrued during such year, and, if such liability is lessened by unexpected events occurring in a subsequent year, after the income tax return has been filed, proper accounting practice requires that this be reflected by an entry in the subsequent year, crediting as income the amount by which the obligation has been so lessened, rather than by re-opening and adjusting the taxpayer's books for the previous year." (Citing numerous cases)

In **Bartles-Scott Oil Co. v. Commissioner**, 2 B.T.A. 16, the board held:

"The mere fact that some deferred charges and credits to income may not have been included in the accounts carried cannot destroy

the principle upon which the system of accrual bookkeeping is based."

In Sneed v. Commissioner of Internal Revenue, 119 F. (2d) 767-771 (5th Cir.):

"Congress could fix decennial periods instead of annual ones. It has in general adopted the annual plan, but has authorized either actual receipts and disbursements or accrual as the basis for accounting. On the latter basis, there may be a difference of years in entering the items on the account from what would have been true on a basis of actual receipts and disbursements. But these two bases are elastic, for in the Revenue Act of 1926, Sec. 200(d), 26 U.S.C.A. Int. Rev. Acts, page 146, which directs income and deductions to be accounted for in the year received and paid or accrued, there is an exception: 'Unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.' Similar language occurs in the other Acts. The clear reflection of income that ought to be taxed is the main object. See *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493, at page 498, 58 S. Ct. 673, 82 L. Ed. 975. With or without the aid of a Regulation, there have been many cases of this so-called 'restoration to income' of a deduction taken in a prior year. On the accrual basis, if a tax, or expense, or other deduction is taken one year as accrued, but it turns out in another year that there was no such liability or a less one, the matter is corrected by a charge to income as though there had been a recovery back. *Charleston & W. C. Ry. Co. v. Burnet*, 60 App. D.C. 192, 50 F. (2d 342; *Chicago, R. I. & P. Ry. Co. v. Commissioner*, 7 Cir. 47 F. 2d 990; *Nash v. Commissioner*, 7 Cir., 88 F. 2d 477. So when on a cash basis a debt is deducted as bad and in another year is col-

lected in whole or in part, the matter is corrected not by going back to the year of deduction, but by a charge to income in the later year. *Askin & Marine Co. v. Commissioner*, 2 Cir., 66 F. 2d 776; *Putnam Bank v. Commissioner*, 5 Cir., 50 F. 2d 158."

In Vol. 1 *Mertens Law of Federal Income Taxation*, Sec. 11.14, p. 493, the author says:

"§ 11.14.—The Taxpayer Must Select One Method of Accounting. As has been seen, the statute recognizes at least two methods of accounting. It is clear that the same taxpayer cannot at one time have two bases of accounting; he may not use inconsistent bases at the same time. He may not combine the cash and accrual bases. He must use one method or the other. Amounts of income within the year under the method employed must be returned that year even though part may have been improperly reported in some other year. It will not be presumed that an item was omitted in a previous year. The method of accounting used by the taxpayer must be **'consistent within its own sphere.'** Two distinct businesses of an entirely different character owned by the same individuals but operated independently and keeping separate accounts need not report on the same accounting basis. What accounting method is used is determined by the facts, not by what the method used is called. **But this does not mean that a method must be 100% cash or accrual; minor deviations from the cash basis are not sufficient to cause books to be placed upon the accrual basis. The converse is also true. A hybrid method is not acceptable, but a method may be substantially or fundamentally the accrual method and not a hybrid method. To be kept on the accrual basis the books need not have every element of the high-**

est scientific accrual method. The general and controlling character of the accounts determines which method is employed, not the label which the taxpayer chooses. It has been held that evidence as to accounting method in years other than the taxable year is admissible in determining a question as to the taxable year since 'the entire story is pertinent and useful.' It is not possible to adhere to absolutely definite rules in all types of businesses and minor departure will not necessarily cause the scale to turn for or against the method insisted upon. There must not be a too strict regard for insignificant errors or too slavish adherence to prescribed theories or methods. The controlling intendment of the statute must be kept in mind that a method of accounting should be followed if it substantially reflects true income."

In Willoughby Camera Stores v. Com'r of Internal Revenue, 125 F. (2d) 607-608 (C.C.A. 2d, 1942), the court held:

"The issue here is whether petitioner was entitled to deduct from gross income, as business expenses under § 23 (a) of the Revenue Acts of 1934 and 1936, 26 U.S.C.A. Int. Rev. Code, § 23 (a), certain amounts which it set up on its books as reserves for employees' bonuses. The amounts were deducted in 1935 and 1936, although not paid until the following years, and the disputed question is whether the taxpayer, which is on the accrual system, was entitled to make the deductions in the earlier years. The Board of Tax Appeals held that there was, when the accounts were set up, no legal liability to pay the amounts credited to the bonus reserve. We disagree.

"Mr. Riggles, president of the corporation, testified that, at the time of hiring, the em-

ployees (who are called 'co-workers') 'are told that we run a cooperative organization, that they are co-partners of the business, and after two years' service they participate in a general bonus distribution.' While 'co-partners' may be too glorified a title for an employee whose claim to it is membership in a profit-sharing scheme, petitioner has succeeded in establishing that it was **obligated to pay bonuses in some amount**. Where such an inducement is held out to an employee at the time of hiring, it is familiar doctrine that there is an **implied contract to make payments**. See Annotation, 28 A.L.R. 331. This is in accord with the reasonable expectation of the employee, an expectation which is heightened where, as here, similar hopes have been stimulated in his fellow-employees and where the employer's custom has been to satisfy those hopes. In such circumstances, it has been held, the employee may sue for his bonus, though his recovery may be limited to a nominal amount. He is protected, furthermore, against a forfeiture of his rights by an arbitrary discharge. Annotation, 28 A.L.R. 346.

"No doubt the obligation imposed on the employer by such a contract, while the amount remains both unknown and unknowable, will not serve as the basis of a deductible accrual. On the other hand, **there can be no doubt about the deductibility of an accrual, if the amount thereof may be determined by a fixed formula**, as by a percentage of profits. Petitioner argues, and we agree, that an adequate substitute for such a formula is to be found in the fact that in December of each year the board of directors meets to determine how much shall be paid as bonuses during the next year. Following this determination, a memorandum is handed to the treasurer, who credits this amount to 'Reserve for Bonus or Extra Com-

pensation' and charges it to profit and loss. The **action of the board of directors**, while not as inflexible as a formula, **must be regarded**, in view of the company's custom, as **definitely fixing a minimum for the amount to be paid**. The amount was known to the employees, . . . As in the case of Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 52 S. Ct. 529, 76 L. Ed. 1111, **all the events necessary to a determination of the amount to become due were present in the taxable years.** (Cases)

"The Board of Tax Appeals held that an employee of the taxpayer could not ascertain, within the taxable year, his proportionate share of the accrual. We do not regard that as relevant to the issue of deductibility. If the directors' decision had been subject to revocation, the existence of a formula by which an employee could compute his share of a tentative amount would add nothing to the propriety of an accrual; similarly, if the sum was set aside finally and without reservation as a liability to the group, the absence of a formula for individual distribution would in no way impair the accuracy, from an accounting point of view, of the accrual as a reflection of the company's affairs. **In view of the custom followed by this company**, we think that its promise to its 'co-workers' was twofold: (1) to pay at least some amount as a bonus, and (2) to pay at least the amount, if any, set up on its books at the end of each year as a reserve for bonuses. Thus the **enforceable obligation** to pay a nominal sum, found in the usual case, was in this one supplanted at the time of the directors' meeting by a **promise to pay in the aggregate, at least the amount set up in the reserve**. That obligation could have been enforced by the employees as a class, and we do not think that a court would be unable to devise some equitable method for apportioning

the sum among them. The fact that no date for payment was set at the December meeting is irrelevant; under the accrual system of accounting the use of the word 'accrued' does not signify that the item is due. On the contrary, the accrual system wholly disregards due dates. *United States v. Anderson*, 269 U.S. 422, 425, 46 S. Ct. 131, 70 L. Ed. 347. If the issue here were when payment becomes due, we would be required to select some date reasonable under the circumstances, presumably the end of the succeeding year; but we are not faced with that task.

"Since there was an obligation enforceable within the taxable year, the deductions were proper. The order of the Board of Tax Appeals, therefore, is reversed."

In *Helvering vs. Russian Finance & Construction Corp.*, 77 Fed. (2d) 324 (2d Cir.), the taxpayer agreed to purchase from an organization six hundred thousand tons of ore and to pay therefor at a fixed price scale plus a bonus of \$2.00 per ton to be paid at the expiration of ten years from the date of the agreement with interest payable semi-annually from the date of deliveries. The taxpayer was on the accrual basis and according accrued all purchases of the ore thus obtained in the years when the purchases were made and accrued the full sum of \$1,200,000.00, being the \$2.00 per ton for the six hundred thousand tons in the three years that it obtained delivery of said ore, and took the amount so accrued as a deduction in the years in which they were accrued as liabilities. The Commissioner of Internal Revenue disallowed this de-

duction contending that the amount was not properly accrued in those years, the court held:

“In order to be accruable in the taxable year for which the return is made, a valid obligation to pay must have existed in that year, which is enforceable on the date when the obligation is due.

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“When the right to receive income or the obligation to expend money is certain, not dependent upon the happening of some contingency, it may be classified as accrued.

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“The taxpayer’s liability became fixed upon delivery of the ore, and there then existed reasonable grounds to justify the taxpayer in believing that it would ultimately have to pay the \$1,200,000. A presently existing obligation, which the taxpayer has reasonable grounds to believe must eventually be fulfilled, is **not uncertain or contingent** in the sense that it may not be accrued. See *Automobile Ins. Co. v. Comm’r*, 72 F. (2d) 265 (C.C.A. 2).

“The basis of the accrual system of accounting is that obligations incurred in the normal course of business will be discharged in due course. *United States v. American Can Co.*, 280 U.S. 412, 50 S. Ct. 177, 74 L. Ed. 518. This is a necessary assumption. Conditions in the contract which would here have discharged the taxpayer from the liability it incurred upon delivery of the ore were not of a nature which would justify it in believing it would not have to pay the \$1,200,000. The conditions never occurred, as the record disclosed, and **the liability was in fact discharged by payment**. When books are kept on an accrual basis, a presently existing obligation, which, in the normal course of events, the taxpayer is justified

in believing he must fulfill, may be accrued.

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“The fundamental requirement is that the return reflects true income, and expenses must be set off against the income to which they are attributable. *United States v. Anderson*, *supra*; *Miller & Vidor Lumber Co. v. Comm’r*, 39 F. (2d) 890, 892 (C.C.A. 5). In the latter case, the court said: ‘We think these cases and the regulations clearly establish the rule that, as to taxpayers making their returns on the accrual basis, deductions attributable to the business of a particular year must be applied against the income they help to create from the business of that year, and not against that of a subsequent year in which payment was made.’

“In the instant case, the contract provided that payment of the \$2 per ton was additional payment for the ore. Consequently, the \$1,200,000 constituted part of the cost of the ore, and the taxpayer so entered this cost upon its books. When the ore was sold by the taxpayer during the taxable years in question, the true income derived from such sale could be ascertained only by offsetting the complete cost of the ore, including the \$1,200,000, against the price received upon its sale. Postponing the deduction to the year when the \$1,200,000 was actually paid would not reflect true income for that year, but would distort the income.”

In *United States v. Anderson*, 269 U.S. 422; 46 Sup. Ct. 131, the taxpayer in the year 1916 sold munitions upon which it was required to pay munitions’ taxes. These taxes were due and payable in 1917 and were paid in that year. Taxpayer took as a deduction in 1917 the amount so paid. The commissioner disallowed the deduction on the ground

that the taxpayer was on the accrual basis and should have taken the deduction in 1916. The Supreme Court held:

“Only a word need be said with reference to the contentions that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, **all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.** In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee’s books. **In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued.**

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“We conclude that the reserves for taxes which appeared on appellee’s books in 1916 were deductible under section 13(d) (now sec. 23) of the Act of 1916 and Treasury Decision 2433 in its income tax return on the accrual basis for that year.

“It was argued in behalf of the appellees in No. 337 that the taxpayer did not keep its books on an accrual basis;

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“On this point we are concluded by the findings.”

Re: Statute of Limitations

In *Ronald Press Co. v. Shea*, 27 Fed. Supp. 857-863, affirmed 114 Fed. (2d) 453 (2d Cir.), the original complaint sought refund of taxes paid upon determination of a deficiency resulting from the liquidation of subsidiary companies. By the amended complaint plaintiff sought recovery for **additional loss sustained in the same tax year**, resulting from the charging off of bad debts transactions distinct from those involved in the original complaint. The court held:

“The first special defense is that the amended complaint set forth new and distinct causes of action, which were not contained in the original complaint and were **not brought within the time limited by law for commencing an action thereon**, and are therefore barred. I think the defense is good. It is true that ‘a liberal rule should be applied.’ *New York Central & H. R. R. Co. v. Kinney*, 260 U.S. 340, 346, 43 S. Ct. 122, 123, 67 L. Ed. 294 and that **Rule 15(c)** of the new Federal Rules of Civil Procedure which went into effect September 16, 1938, 28 U.S.C.A. following section 723c, permits the amended pleading to date back to the original pleading, where the claims asserted in the amended pleading arose out of the transaction set forth or attempted to be set forth in the original pleading. But the amended complaint does not meet the condition. Not only are the amounts and dates different but there are pleaded certain basic allegations, such as the making of the agreement of January 3, 1928, which are not mentioned in the original complaint. Likewise, there are important allegations of the original complaint which do not

appear in the amended complaint. (Compare paragraphs 9, 22 and 24 of the original complaint with paragraphs 13 and 14 of the amended complaint.) Having in mind the provisions of the stipulation and the special defense, I conclude that the causes of action pleaded in the amended complaint are barred by the Statute of Limitations controlling suits against the United States to recover taxes illegally collected. 26 U.S.C.A. §§ 1672-1673 and notes thereunder.”

In **McEachern v. Rose**, 302 U.S. 56; 58 S. Ct. 84, plaintiff sued to recover a refund. Defendant interposed a barred set-off against the tax liability. The Government relied upon the principle set forth in **Lewis v. Reynolds**, 284 U.S. 281; 52 S. Ct. 145 (the case which defendant relies on in the base at bar). (See decision of Circuit Court of Appeals, 86 F. (2d) 231.) The Supreme Court of the United States held:

“We may assume that, in the circumstances, equitable principles would preclude recovery in the absence of any statutory provision requiring a different result. But Congress has set limits to the extent to which courts might otherwise go in curtailing a recovery of overpayments of taxes because of the taxpayer’s failure to pay other taxes which might have been but were not assessed against him. Section 607 of the 1928 Act (26 U.S.C.A. Sec. 3770 (a) (2)) declares that any payments of a tax after expiration of the period of limitation, shall be considered an overpayment, and directs that it be ‘credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim;’ and section 609 (a) of the 1928 act (26 U.S.C.A., Sec. 3775

(a)) provides that ‘any **credit** against a liability in respect of any taxable year **shall be void** if any payment in respect of such liability **would be considered an overpayment** under section 607 (3770(a)(2)).’ These provisions preclude the government from taking any benefit from the taxpayer’s overpayment by **crediting it against an unpaid tax whose collection has been barred by limitation.**

“It is plain that **these provisions forbid credit** of the overpayments of taxes for 1930 and 1931, which were made after collection of the 1928 tax was barred. If petitioner had then paid the 1928 tax, there would have been an overpayment of the tax, refund of which is made mandatory by section 607. **Credits** against the tax of overpayments of taxes assessed for other years, if made at that time, could not stand on any different footing under the provisions of section 609 (26 (U.S.C.A., Sec. 3775)). The right of the government to credit the overpayments upon the earlier unpaid tax could arise only when the overpayments occurred; but **since** at that time **collection** of the 1928 tax was barred by limitation, and payment of it would be an overpayment, **credit against it of the 1930 and 1931 overpayments was forbidden** by section 609 (3775).

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“If petitioner had then paid the (barred) tax he could have recovered it back as an overpayment under section 607 (3770) ; accordingly, credit against the tax of the 1929 overpayment is prohibited by section 609 (3775), as are like credits for the overpayments of 1930 and 1931.

“The similar treatment accorded by the statutes to credit against an overdue tax, and to payment of it; the prohibition of credit of an overpayment of one year against a barred deficiency for another; and the requirement

that payment of a barred deficiency shall be refunded, are **controlling evidences of the congressional purpose** by the enactment of sections 607 (now 3770) and 609 (3775) **to require refund** to the taxpayer of an overpayment, even though he has failed to pay taxes for other periods, whenever their collection is barred by limitation."

In **Rothensies v. Electric Storage Battery Co.**, 329 U.S. 296; 67 S. Ct. 271, the taxpayer insisted on the right to set off the amount of his claim for refund which was barred by the statute of limitations against his subsisting tax liability. **The Government made the same contention as the plaintiff makes in the case at bar**, namely, that a barred liability cannot be set off against a subsisting liability and the Government was sustained in that contention. The court held:

"It probably would be all but intolerable, at least Congress has regarded it as illadvised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. **Hence a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.**

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"As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayer and losses to the revenues may be pointed out.

They tempt the equity-minded judge to seek for ways of relief in individual cases.

“But if we should approve a doctrine of recoupment of the breadth here applied we would seriously undermine the statute of limitations in tax matters. In many, if not most, cases of asserted deficiency the items which occasion it relate to past years closed by statute, at least as closely as does the item involved here. Cf. *Hall v. United States*, 95 Ct. Cl. 539, 43 F. Supp. 130. The same is true of items which form the basis of refund claims. Every assessment of deficiency and each claim for refund would invite a search of the taxpayer’s entire tax history for items to recoup.

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“We cannot approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim. If there are to be exceptions to the statute of limitations, it is for Congress rather than for the Courts to create and limit them.”

In *American Light & Traction Co. v. Harrison*, 142 F. (2d) 639 (7th Cir.), the court held:

“Plaintiff brought this action to recover \$251,053.55 in income taxes admittedly overpaid for 1933. Although he admitted every allegation of fact contained in plaintiff’s complaint, defendant endeavored to defeat recovery by affirmatively pleading that plaintiff had underpaid its taxes for 1928 by \$342,180.50, the collection of which was barred by the statute of limitations.

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“The Government’s failure to collect the tax for 1928 was not caused by any misrepresentation or misleading silence on plaintiff’s

part, but resulted from an opinion of the General Counsel for the Bureau which, in 1940, turned out to be erroneous under *LeTulle v. Scofield*, 308 U.S. 415, 60 S. Ct. 313, 84 L. Ed. 355.

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"Since an action to recover a federal tax erroneously paid is in the nature of a common law action for money had and received and is governed by equitable principles, *United States v. Jefferson Electric Mfg. Co.*, 291 U.S. 386, 402, 403, 54 S. Ct. 443, 78 L. Ed. 859, and since equitable principles would preclude a recovery in the instant situation, plaintiff could not recover if there were no statutory provisions involved. Here, however, there are such provisions which cannot be ignored.

"Section 607 of the Revenue Act of 1928, 45 Stat. 791, 874, 26 U.S.C.A. Int. Rev. Code, § 3770(a) (2), which is significantly entitled 'Effect of Expiration of Period of Limitation Against United States,' provides that any payment of a tax after the expiration of the applicable period of limitation shall be considered an overpayment and directs that it be '* * * credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim.' Under this section, any payment of the barred deficiency for 1928 would constitute an overpayment, the refund of which would be mandatory. Section 609(a) provides that 'Any credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment under section 607.' 45 Stat. 875, 26 U.S.C.A. In Rev. Code, § 3775 (a). Since the payment of a barred deficiency for 1928 would constitute an overpayment under § 607 (now 3770), it necessarily follows that any credit of the 1933 overpayment

against that barred deficiency would be void under § 609(a) (now 3775). In the light of these provisions, the only possible conclusion is to affirm the District Court's judgment for the plaintiff. Any other result would effect a judicial repeal of the Act of Congress.

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"Probably moved by the desire to stimulate voluntary payment of taxes by giving the taxpayer an immediate refund right free from the danger that it would be credited against any stale deficiency, Congress enacted the instant statutory provisions. At any rate, Congress did enact these provisions which we are not free to suspend or apply at will, nor to shape to our notion of the ends of justice. Although here a hardship on the Government results from the taxpayer's inconsistency, the correlative provisions of this same statute will, in the converse of the instant situation, work an equal hardship on the taxpayer. *Hall v. United States*, Ct. C., 43 F. Supp. 130. In the instant case, our power to construe the statute is narrower than usual and closely circumscribed, because the Supreme Court has given an authoritative interpretation in the *McEachern* case.

"The judgment is affirmed."

In *Grand Central Public Market v. United States*, 22 F. Supp. 119-131 (Calif.), the court held:

"In this recent *McEachern* Case it was held that the equitable defense of setoff, unjust enrichment, or recoupment is not available to the government if the application of such a defense would result in crediting a later overpayment upon a barred tax liability

"It is indeed unfortunate that in this instance the plaintiff will be able to avail itself

of the technical defense of the statute of limitations, in order to avoid the collection by the government of a very considerable sum in income taxes for the years 1925 to 1928, inclusive. These taxes, plaintiff at one time properly and legally owed, but **no fraud or concealment has been alleged or proved by the government** and we feel that the bonus receipts were known or should have been known at all times to the Commissioner's agents. To ignore the statute would in our judgment, produce results much more serious than any possible loss of revenue. Congress certainly had a special object in view in enacting the statute of limitations and, to accept the theory of the defendant in this case, would be to defeat the clear intent of Congress to fix a definite period of time as a limit upon collectibility of income tax.

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"Under the circumstances we are unwilling to reduce or wipe out plaintiff's recovery by offsetting the taxpayer's liability for any year prior to 1929."

In **Lyeth v. Hoey**, 112 F. (2d) 4 (2d Cir.), plaintiff sued for refund of taxes. Defendant interposed a set-off based on a claim for unpaid taxes which was barred by the Statute of Limitations at the time the answer was filed. The court held:

"Section 609(a) (now 3775) prevents the government from crediting barred taxes upon the claim of a taxpayer for overpayment of any tax and section 609(b) in like manner protects the government against a credit of a claim for barred taxes of any kind."

In **Rotenberg v. Sheehan**, 48 F. Supp. 584-587, the court held:

“The amount of unpaid taxes on independent transactions may not, after their collection is barred by the Statute of Limitations, be set off against claims for refund. *McEachern v. Rose*, 302 U.S. 56, 58 S. Ct. 84, 82 L. Ed. 46.”

In *Hall v. United States*, 43 F. Supp. 130-134, Court of Claims, Certiorari Denied, 62 S. Ct. 944, the situation was reversed. The taxpayer claimed the right to recoup against a tax liability a claim for refund which was barred by the Statute of Limitations.

The Government made the same contention in that case that the taxpayer makes in the case at bar, namely, that the barred claim for refund could not be off-set against a tax liability and the Government's contention in that respect was sustained. The court held:

“Plaintiff's facts come so squarely within the terms of these two sections (referring to 3770-3775) when construed together, that to permit recovery by way of recoupment, under the facts as disclosed by the record would be tantamount to judicial repeal of the statutory limitation provisions enacted by the Congress.

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“At any rate, the Congress, in its discretion and within its province, has enacted these provisions. We are not privileged to suspend or apply them at will, nor to shape them to our notion of the ends of justice.”

In *West Virginia Pulp & Paper Co. v. McElligott*, 40 F. Supp. 765-771, the court held:

"The defense of recoupment is available as to all three of plaintiff's actions. *Lewis v. Reynolds*, 284 U.S. 281, 283, 52 S. Ct. 145, 76 L. Ed. 293; *Stone v. White*, supra, 301 U.S. page 538, 57 S. Ct. 851, 81 L. Ed. 1265; *Routzahn v. Brown*, 6 Cir., 95 F. 2d 766, 769. **McEachern v. Rose**, 302 U.S. 56, 58 S. Ct. 84, 82 L. Ed. 46, does not take away the defense of recoupment in the cases at bar. **In that case statutory provisions, Sections 607 and 609 of the 1928 Act, 26 U.S.C.A. Int. Rev. Acts, pages 459, 460, make the defense unavailable.** 'We may assume that, in the circumstances, equitable principles would preclude recovery in the absence of any statutory provision requiring a different result.' *McEachern v. Rose*, supra, 302 U.S. page 59, 58 S. Ct. page 85, 82 L. Ed. 46.

"The taxes sought to be recovered by these suits were **paid long before the enactment of Sections 607 and 609.** It is the policy of Section 609(a) 'to stimulate voluntary payment of taxes by giving the taxpayer an immediate refund right free from the danger that it will be credited against a stale deficiency'."

In **Penn v. Robertson**, 29 F. Supp. 386-388, the court held:

"It is insisted by the Commissioner that the deficiency for the year 1929 should be deducted from the overpayment on the authority of *Bull v. United States*, 295 U.S. 247, 55 S. Ct. 695, 79 L. Ed. 1421. But the facts of the instant case bring it within the rule announced in *McEachern v. Rose*, 302 U.S. 56, holding that a tax already barred cannot be off-set against an overpayment."

No. 12073

**In the United States Court of Appeals
for the Ninth Circuit**

J. W. MALONEY, UNITED STATES COLLECTOR OF INTERNAL
REVENUE FOR THE DISTRICT OF OREGON, APPELLANT

v.

ROSS B. HAMMOND, APPELLEE

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR
THE DISTRICT OF OREGON

PETITION BY THE APPELLANT FOR REHEARING

THERON LAMAR CAUDLE,

Assistant Attorney General.

ELLIS N. SLACK,

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*ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR
THE DISTRICT OF OREGON*

PETITION BY THE APPELLANT FOR REHEARING

To the Honorable the Judges of the United States
Court of Appeals for the Ninth Circuit:

J. W. Maloney, Collector of Internal Revenue for the
District of Oregon, petitions for a rehearing in the
above entitled case for the following reason:

In the opinion filed September 7, 1949, the Court
failed to decide on the merits the second question pre-
sented, namely, whether the amounts of \$86,635.88 in
1942 and \$77,366.37 in 1943, accrued by taxpayer to the
accounts of Mason and Peterson under their profit
sharing agreements, are allowable deductions in those
years. The District Court decided this question on the
merits, holding that the deductions were properly taken

by the taxpayer in 1942 and 1943 and are allowable (R. 33, 35, 38-39) and one of the points on appeal specifically relates to this holding (R. 48-49).

In the last two paragraphs of its opinion this Court held that it could not find an abuse of discretion in the denial by the District Court of the Collector's motion to amend his answer to plead as a set-off to the refund claimed the tax which results from disallowance of the Mason and Peterson deductions referred to above, since the amended answer does not appear in the record. Apparently, therefore, this Court took the view that the question as to the allowability of the deductions for profits accrued to Mason and Peterson was not raised by a pleading of the Collector and was thus not properly before it.

It is, however, submitted that the issue is present in the case even though it was not asserted by the Collector's answer or by amended answer. This is a suit by the taxpayer for a refund of taxes paid for 1942-1943 and he is not entitled to a judgment unless he has in fact overpaid his taxes for those years. To the extent of the deductions in respect of amounts accrued to Mason and Peterson, if erroneously taken in those years, he underpaid his taxes and the resulting underpayment must be subtracted from the tax which was paid in order to arrive at the amount overpaid for which judgment may be given. This is true even though the statute of limitations would bar the Commissioner of Internal Revenue from assessing and collecting an additional tax for the years in suit. These principles are fully established by *Lewis v. Reynolds*, 284 U.S. 281, 599.¹ Thus, the question of whether the deductions were

¹ The cases of *McEachern v. Rose*, 302 U.S. 56, and *Rothensies v. Electric Battery Co.*, 329 U.S. 296, as well as other cases on which the taxpayer relied (Br. 73-77), involved different questions and do not affect the authority of *Lewis v. Reynolds*, *supra*. In the *McEachern* case it was held that a tax liability for one year, assess-

properly taken in 1942 and 1943 by the taxpayer was an essential element in determining the taxpayer's right to a refund of taxes paid for 1942-1943 and the amount thereof, and since this is so, there was no necessity that the question be affirmatively pleaded by the Collector. Similarly, since an essential element of taxpayer's case was to establish that the deductions were properly taken in order to establish his right to a refund in this suit against the Collector, the United States was not a necessary party to the suit. Cf. *Lewis v. Reynolds, supra*, where the United States was not joined as a defendant with the Collector.² Indeed, in this posture the principal reason for filing an amended answer in this case would be to advise the taxpayer of the Government's position that the amount of profits accrued by taxpayer to the accounts of Mason and Peterson were not properly deductible. But this purpose was served even though the amended answer was not actually filed. The taxpayer's objections to the motion for leave to file an amended answer state (R. 8) that the amended answer was tendered with the motion and the taxpayer was thus

ment of which was barred by the statute of limitations, could not reduce overpayments of taxes for other years, refund of which was sought in the suit. The *Electric Battery* case held that a barred claim for refund of excise taxes for one period could not be recouped against an income tax owing for the year 1935. These decisions of course recognize the basic premise that taxes for different years and different kinds of taxes are different causes of action. But the present case, like *Lewis v. Reynolds, supra*, does not involve an attempt to setoff a tax for one year against a refund of tax for another year. On the contrary it involves a suit for refund of income taxes paid for 1942-1943 and the question is whether the tax for those years has been overpaid. If erroneous deductions were taken in those years, there has been no overpayment to that extent.

² The statement in the affidavit of Thomas R. Winter in support of the motion for leave to file an amended answer (R. 7-8) that the United States was a necessary party to the suit was made because the Government was then endeavoring to assert a counterclaim for an affirmative judgment of \$6,554.03 against the taxpayer to which the United States would have been a necessary party. See Finding 26 (R. 36-37).

on notice of the Government's position. In any case, evidence on the merits on this question was offered and received at the trial and, as stated, the District Court decided the question on the merits. The Collector's statement of points on appeal (R. 48-49) asserts error both as to the holding on the merits that the deductions were allowable and as to the denial of the motion to amend. Thus, the question on the merits is properly before this Court and must be decided, even though the Court decided in the opinion of September 7, 1949, that the District Court did not abuse its discretion in denying the motion to file ~~an~~ amended answer.

It is therefore respectfully requested that this Court grant a rehearing and decide the issue as to the propriety of the deductions. As the Collector's brief shows (pp. 24-26), the amounts credited to Mason and Peterson on taxpayer's books in 1942 and 1943 were not properly accruable as deductions because the taxpayer was not unconditionally obligated to pay the amounts in those years. Second, even if it is assumed *arguendo* that the amounts were properly accruable, Section 23 (p) (1) (D) of the Internal Revenue Code nevertheless bars the right to deduct the accrued items until the year or years in which the amounts were actually paid. (See Br. 26-27.) It is clear that the facts of this case fall precisely within the terms of Section 23 (p) (1) (D). See Section 29.23 (p)-1 of Treasury Regulations 111 (Appendix, *infra*). Taxpayer relies on the part of the regulation which states that the provision is not intended to cover the case where payment of compensation is deferred until after the year of accrual merely because of inability of the employer to pay the compensation in the year of accrual. There is no showing here, however, that the taxpayer was unable to pay the accrued compensation to Mason and Peterson in 1942 and 1943. Although

the agreements with Mason and Peterson provided that taxpayer might retain their shares of the profits in excess of their drawings as working capital, this provision at best simply relieved taxpayer of the necessity in the future of securing working capital in the amounts to be accrued from other sources. There is no indication that taxpayer could not have obtained working capital of \$86,635.88 at the end of 1942 and \$77,366.37 at the end of 1943 in some other manner and thus the inference is compelled that the retention of these amounts of compensation in the taxable years was simply a convenience to him, rather than a financial necessity.

The Court should hold that the deductions of \$86,635.88 in 1942 and \$77,366.37 in 1943 are not allowable.

While we are of the firm conviction, for the reasons heretofore given, that the filing of the amended answer was unnecessary to raise the issue as to the propriety of the deductions here in question on the merits, nevertheless if the Court feels that the amended answer is necessary or desirable to a consideration of the question on the merits, it is requested that the Court direct the District Court to certify the proposed amended answer, which was attached to and tendered with the motion for leave to file. (R. 8, 11, 18-19.) This is clearly within the Court's power under Rule 75(h), Federal Rules of Civil Procedure. The request to supplement the record is proper and should be granted even though the Court's opinion and judgment have already been rendered. Cf. *American Chemical Paint Co. v. Dow Chemical Co.*, 164 F. 2d 208 (C.A. 6th). Upon receipt of the amended answer, the Court will see that it asserted as a defense to the taxpayer's claim for refund that taxpayer had not overpaid his taxes for 1942-1943, since he erroneously deducted the

amounts of \$86,635.88 in 1942 and \$77,366.37^{in 1943} and that the District Court abused its discretion in not granting leave to file it, in order that the Government's position might be set forth in the pleadings.

Respectfully submitted,

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HENRY L. HESS,
United States Attorney.
 VICTOR E. HARR,
Assistant United States Attorney.
 SEPTEMBER, 1949.

CERTIFICATE OF COUNSEL

The appellant herein, by its attorneys, hereby certifies that the foregoing motion is not presented for the purpose of delay or vexation, but is, in the opinion of counsel, well founded and proper to be filed herein.

THERON LAMAR CAUDLE,
Assistant Attorney General.
 ELLIS N. SLACK,
 A. F. PRESCOTT,
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 VICTOR E. HARR,
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 SEPTEMBER, 1949.

APPENDIX

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.23(p)-1. *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred Payment Plan—In General.*—Section 23 (p) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. * * * Section 23 (p), however, is applicable to all contributions under a stock bonus, pension, profit-sharing, or annuity plan, whether or not the employees' rights in such contributions are non-forfeitable.

A contribution to be deductible under section 23 (p) must be an ordinary and necessary expense which would be deductible under section 23 (a) if it were not for the fact that the statute specifically provides that it shall be deductible under section 23 (p). A contribution by a corporation under a plan which is created primarily for the purpose of benefiting shareholders of the company is not deductible. Such contribution may constitute a dividend within the meaning of section 115 (a). A contribution under a plan that is set up for the exclusive benefit of employees as such, and thus represents an item of expense, is of the nature of compensation for personal services rendered by the employees covered by the plan. The amount of contributions allowable as a deduction has an over-all limitation—the entire contributions for the taxable year when added to other compensation paid must represent reasonable compensation for services rendered by the employee beneficiaries. * * * In the case of a stock bonus or profit-sharing plan which provides for additional compensation for employees not paid as a pension, a contribution

will not be fully deductible unless it can be justified as a reasonable addition to the compensation otherwise paid to employees who are beneficiaries under the plan. In addition to the over-all limitation referred to above, section 23 (p) sets forth further limitations as to the amounts that may be deductible for the taxable year.

Section 23 (p) is not confined to formal stock bonus, pension, profit-sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. * * * If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

Deductions under section 23 (p) are generally allowable only for the year for which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his return on the accrual basis. * * *

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